PROCEEDINGS

OF THE SECOND ANNUAL

Institute on Accounting

Held At

THE OHIO STATE UNIVERSITY

MAY 19 AND 20, 1939

Sponsored by

THE DEPARTMENT OF ACCOUNTING
COLLEGE OF COMMERCE AND ADMINISTRATION
THE OHIO STATE UNIVERSITY

Edited by

THE BUREAU OF BUSINESS RESEARCH
COLLEGE OF COMMERCE AND ADMINISTRATION

FOREWORD

In 1938, the College of Commerce and Administration developed a comprehensive College-wide program of public conferences and institutes. This program was planned to make possible the extension of the resources and special facilities of the College for the analysis of important problems of business policy and practice. Five such conferences were held in 1938.

The success of these meetings, as indicated by attendance at the sessions, comments of those attending, and interest in the published Proceedings, was a convincing demonstration of their need and value. The hope of the College that these conferences might provide a fund of ideas and experience to which both the University and the business world should contribute, and from which each should benefit, seemed to attain some measure of fulfillment.

The conference program for 1939 therefore represents a continuation of these plans and objectives.

The 1939 Institute on Accounting is the second annual meeting on accounting problems and practice to be held at The Ohio State University under the sponsorship of the College of Commerce and Administration.

The Institute was planned and conducted under the leadership of the staff of the Department of Accounting. The College desires to express its appreciation of their efforts in making the 1939 Institute on Accounting again a definite success.

W. C. WEIDLER, *Bean*
College of Commerce and Administration

FACULTY OF THE DEPARTMENT OF ACCOUNTING

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Member of American Institute of Accountants, American Accounting Association, and The Ohio Society of Certified Public Accountants.

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WALTER BURNHAM, C.P.A.

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DEPARTMENT ASSISTANTS

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PREFACE

On May 19 and 20, 1939, it was again the pleasure of members of the staff* of the Department of Accounting to welcome a fine group of accountants to the annual Institute on Accounting at The Ohio State University.

The analysis of registration statistics shows the following facts relative to attendance:

Total Registrations		265
Distributed as follows:		
Public accountants		82
Industrial accountants		59
Corporate officials, public officials, and others.		24
University officials and instructors:		
Ohio State University	27	
Other	14	
	—	41
Ohio State University students		59
Total registrations (as above)		265

The attendance came from 9 different states: Ohio, New York, West Virginia, Michigan, Illinois, Indiana, Iowa, New Jersey, and Pennsylvania.

Memberships held in professional accounting societies by registrants:

State societies of certified public accountants:	
Ohio	56
Other	9
American Institute of Accountants	39
National Association of Cost Accountants	53
American Accounting Association	9

Student members of Omicron Chapter of Beta Alpha Psi, the National Accounting Fraternity, assisted in the registration, ushering, and other necessary services during the two-day meeting.

The Defartment of Accounting

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FIRST SESSION

FRIDAY, MAY 19, 1939—10 A.M.

Commerce Auditorium

Chairman:

HOMER L. DALTON, *C.P.A., President, The Ohio Society of Certified Public Accountants*

Address of Welcome:

DR. WILLIAM MCPHERSON, *Acting President, The Ohio State University*

Topic: The Need for Uniform and Coordinated Effort in the Development of a Statement of the Principles Underlying the Practice of Accounting

Papers:

ALBERT W. TORBET, *C.P.A., Partner, Frazer and Torbet, Chicago, Illinois*
SIDNEY G. WINTER, *C.P.A., Professor of Accounting, University of Iowa; President, American Accounting Association*

INTRODUCTORY REMARKS

By HOMER L. DALTON, C.P.A.
President, The Ohio Society of Certified Public Accountants

May the Second Annual Institute on Accounting now come to order.

The attendance response this morning is a token of respect and gratitude to the College of Commerce and Administration of the Ohio State University, the administrative officials of the University, and the other sponsors of this meeting. Last year the Institute on Accounting was attended by approximately 500, with 15 states having representation.

The quality and depth of the subject matter of that program are still a splendid memory. While information relative to the registration and attendance at this meeting today is not yet assembled or complete, it appears that this year's attendance will be equally gratifying. Moreover, a perusal of the program to be offered today and tomorrow definitely assures one that last year's goal has been surmounted, and the timeliness of the subjects for consideration will further stimulate our interest in common current accounting problems.

The Ohio Society of Certified Public Accountants is proud to have the privilege of being represented in this gathering and of being a part of an Accounting Institute that does so much towards solving the problems common to accounting practice and the academic training of men. May I, on behalf of the Ohio Society of Certified Public Accountants, extend to the sponsors of this Institute our felicitations?

Our meeting will now be officially opened by a word of welcome from Acting President William McPherson, of Ohio State University.

Dr. McPherson for a number of years was Professor of Chemistry at The Ohio State University. He was Dean of the Graduate School since its inception in 1914. About two years ago he retired from that capacity and, upon the retirement of President Rightmire, Dr. McPherson was recalled to act as Acting President.

Ladies and Gentlemen, it is a great pleasure to bring to you Dr. McPherson. (Applause.)

ADDRESS OF WELCOME

By DR. WILLIAM MCPHERSON
Acting President, The Ohio State University

The radio tells me that time marches on, and I am reminded of this because it seems to me that it was only yesterday that I had the great pleasure and the honor of saying a word of welcome to the members of the first meeting of this Institute on Accounting.

As your Chairman has said here, the University, and the Department of Accounting because it was responsible in every way for this Institute, I believe, undertook this series with some hesitation. But after last year, there can be no doubt as to the place an Institute like this has in the University. An attendance of something like 500 people from fifteen or more different states means that the University is on the right track in providing these forums for the informed discussion of the pressing problems of the accounting profession.

Now, the University, I wish to say, is proud of sponsoring this Institute, and it hopes that it may have the pleasure of continuing to sponsor it from year to year. And we are not only proud of that, but we are also proud of our Department of Accounting, which has conceived and sponsored these Institutes.

We are proud of the Chairman of that Department, Professor Taylor, former President of the American Association of Accountants. This year, when Governor Bricker—who, by the way, is an alumnus of the University —wanted someone to help unravel the difficulties in the problems of the State, he asked for the loan of Professor Taylor. And I know Mr. Taylor was glad to respond because he is always willing to render service in a worthy cause. He would far rather have remained here and taken care of his academic duties, lectured to his students, and sponsored them, but where duty calls, you can count that he will be there.

And we are proud also of the whole Department of Accounting and of the services that it has rendered in many ways, not only in its training of accountants here, but also in the work that it is contributing to various accounting organizations of our country.

You know, I am beginning to think accountants are pretty good fellows after all. I had the idea, you know, that chemists were the only people in the world—and I haven't changed my ideas about the chemists at all, either—but I guess we will have to allow the sun to shine on the accountants too, because the more I learn about them the more I bide by them. They have problems that must be solved—I can see that. I think it would take a number of accountants to keep track of the debt of the United States, and figure out just when we are going to balance the budget and a few things like that.

Let me again say that we welcome you here and welcome you here most cordially. The University regards it as a great privilege to have these meetings here on the campus. We hope that you will continue to come here from year to year, and that this Institute on Accounting will grow and become even more effective in its service to the profession. The University is yours while you are here. We hope that you will carry away with you the satisfaction of hours well spent, and the resolution to return again and again.

CHAIRMAN DALTON: Thank you, President McPherson, for your cordial welcome. Your University has made a lasting contribution to accountancy education, and this annual Institute on Accounting has attracted national attention. Practicing accountants owe a debt of gratitude to The Ohio State University for sponsoring this meeting and making available its splendid facilities. I sincerely trust that the Institute has become a fixed item on the annual program of your College of Commerce and Administration.

The topic for consideration this morning is "The Need for Uniform and Coordinated Effort in the Development of a Statement of the Principles Underlying the Practice of Accounting." Possibly, at no time in the practice of accountancy has this subj ect occupied a more prominent position. The profession is being driven to the adoption of "uniformity of principles," firstly, by legislation and by the administrative regulations of commissions through their prescribed rules, and secondly, by the changing order of the times, requiring accountants to adopt uniform standards. The voluntary adoption of uniform principles and standards by the profession will materially aid it to consolidate the progress already made and assure its position in further advances.

The activities of the past few years have demonstrated that the accountants prefer to develop and coordinate the "underlying principles" governing the practice of accountancy rather than have uniform rules laid down by another to whom their reports are submitted.

A meeting of this kind, sponsored by an educational institution, affords a great opportunity for the practitioners and those engaged in educational work to coordinate their efforts towards a common goal.

Our first speaker this morning is a graduate of the University of Wisconsin, holds a certified public accountant's certificate from the State of Minnesota, is a member of the Honorary Fraternity, Beta Gamma Sigma, and is a member of the firm of Frazer and Torbet, Certified Public Accountants of Chicago, Illinois. I take pleasure in presenting to you Mr. Albert W. Torbet.

THE NEED FOR UNIFIED AND COORDINATED EFFORT IN THE DEVELOPMENT OF A STATEMENT OF THE PRINCIPLES UNDERLYING THE PRACTICE OF ACCOUNTING

By ALBERT W. TORBET, C.P.A.
Partner, Frazer and Torbet, Chicago, Illinois

I am taking the liberty of using one different word in the subject, and of following the subject as it was originally sent to me rather than as it was placed on the printed program. I am using "unified" instead of "uniform."

From the subject, it might be inferred that the speaker admitted that there was a need for unified and coordinated effort in the development of a statement of the principles underlying the practice of accounting, and that possibly his remarks might be similar to those of a crusader attempting to arouse the accounting profession and others to recognize such a need.

From the press comment regarding accounting practices and the accounting profession, we might infer that the time was ripe for a crusader to appear. During the past ten years the accounting profession and accounting practices have, I believe, received more press comment than any other profession or professional activity. A great deal of the comment, especially by editorial writers, has been in the nature of attacks upon accounting practices and the accounting profession. The attacks have been becoming more intense during the past few years and particularly during recent months. Many people unfamiliar with the nature of accounting and accountants' reports, and the scope and limitation of accountants' reports, have drawn conclusions from the comments in the press that something is radically wrong with accountancy and the accounting profession. Apparently, that is the conclusion which has been reached by many people engaged in many lines of activity, and that conclusion has not been confined to those who are not familiar with the general conduct of business.

The nature of the press comments, particularly those of editorial writers and statements credited to representatives of various governmental agencies, would indicate that there are no generally accepted principles

NOTE: The speaker wishes it made clear that the opinions expressed in this discussion are those of the speaker; they are not the official opinions of any firm, committee of any accountants* society or organization, or any accountants' society or organization.

The term "practice of accounting" as used in this paper refers to such practice by public accountants and by those employed by business enterprises and engaged in public service.

underlying the practice of accounting, and that such principles as exist are followed or ignored at will by the accounting profession. That belief, apparently, is quite widespread.

In preparing the outline for the discussion of the subject, I have attempted to approach it, as I believe an accountant should, from an abstract viewpoint and not as a special pleader who is attempting to prove that the need expressed in the subject actually exists. That approach to the subject has raised numerous questions in my mind, and I believe that a discussion of the subject requires a discussion of the numerous questions.

ANALYSIS OF THE SUBJECT

A. Are there principles underlying the practice of accounting?
B. If there are such principles, what is their nature?
C. Does there now exist any statement of the principles underlying the practice of accounting?
D. If such a statement exists, where can it be obtained?
E. If such a statement exists, why is there a need for unified and coordinated effort in the development of such a statement?
F. If there is need for such unified and coordinated effort, who should exert such unified and coordinated effort?
G. If there is need for a statement of the principles underlying the practice of accounting, how extensive or detailed should such a statement be?
H. If a statement of the principles underlying the practice of accounting is developed, will such a statement have any lasting value or will it become obsolete as soon as it is developed?
I. If a statement of the principles underlying the practice of accounting is developed, what provision could be made to settle differences of opinion respecting such principles?
J. If such a statement is developed and could be adopted, what means could be provided to enforce the provisions of the statement?
K. Is the practice of accounting a profession?
L. Will the practice of accounting remain a profession if such practice must be in accordance with a statement of principles, unless such a statement is general in its nature?

I shall now take up each of these questions individually and give, *in* as objective a fashion as possible, my own views and conclusions.

Are there frincifles underlying the fractice of accounting?

Before answering this question, permit me to outline briefly my conception of the practice of accounting:

(a) The preparation of a chronological record of all transactions.
(b) The classification of all transactions.

(c) The preparation of reports which summarize and classify all transactions.

(d) The review of methods employed in the preparation of the record and classification of transactions, and the accuracy of such record and opinion respecting such matters.

The activities enumerated pertain entirely to past history. The accountant from his intimate knowledge of past transactions is well equipped to pass judgment on the probable effect of contemplated transactions, and the practice of accounting includes advice as to the effect of future transactions, policies, organization and many matters pertaining to the conduct of business and governmental activities.

When I first became interested in the study of accounting, I concluded, after reviewing information which was available more than thirty years ago, that there were principles underlying the practice of accounting, and I still believe that there are such principles.

// there are such fmncifles, what is their nature?

The basic principles underlying the practice of accounting as it pertains to the preparation of a chronological record of all transactions may be stated briefly:

The record must be a complete and accurate record of all transactions, and the record must be supported by and in accordance with the evidence of the transactions.

The basic principles underlying the practice of accounting pertaining to the classification of all transactions may be summarized:

(a) A distinction must be made between the transactions relating to the capital of an enterprise and those relating to the income from and expenses incurred in the conduct of an enterprise.

(b) The transactions relating to capital must be classified in a manner to disclose each kind of asset, each kind of liability, and each kind of proprietary interest.

(c) The transactions relating to income from and expenses incurred in the conduct of an enterprise must be classified to disclose the nature and source of the income and the nature of the expenses incurred.

The basic principles just mentioned may be stated as the basic principles underlying the practice of accounting in the preparation of reports which summarize and classify all transactions, with the qualification that the statements which summarize and classify all transactions cannot show the detailed information disclosed by the records which classify all transactions.

The principles of accounting involved in the review of methods employed in the preparation of the record and classification of transactions, and the accuracy of such record and opinion respecting such matters, may be summarized:

> The reviewer or auditor must make a sufficient examination of the record of all transactions, including the record which classifies the transactions, and the statements which summarize and classify the transactions, together with the methods employed in preparing such record and statements and the evidence of the transactions, to satisfy himself that the transactions recorded are *bona fide* transactions, the record is complete, the classifications and summary statements have been prepared accurately, and that the proper classifications have been made.

Many enterprises involve a parent and subsidiary corporations. Accountants have invented the so-called consolidated financial statements to reflect the transactions of the entire group, although such financial statements do not reflect the transactions of any existing person, corporate or individual. They are in reality hybrid statements. The principles underlying the practice of accounting relating to the preparation of consolidated statements may be summarized:

> All transactions within the group of companies must be disregarded, and the statements disclose the information as it would appear had all of the transactions been conducted by a single entity.

I have indicated briefly the nature of the basic principles underlying the practice of accounting. There are many principles relating to each of the principles stated.

Does there now exist any statement of the principles underlying the practice of accounting?

My answer is yes.

// such a statement exists^ where can it be obtained?

For a source of a statement of the principles, we have the libraries of our schools of business administration and the libraries of the American Institute of Accountants and our state societies of certified public accountants and hundreds of decisions of our courts. There is no manual which sets forth all of the principles underlying the practice of accounting. While it is very easy to state the basic principles underlying the practice of accounting, volumes have been written expanding the principles.

// such a statement exists} why is there a need for unified and coordinated effort in the development of such a statement?

When I first started the study of accounting, a few months short of thirty-two years ago, I had some difficulty in finding a source of information as to the practice of accounting. At that time, experience was thought to be the best teacher. Comparatively few books had been written, and those few pertained principally to the subject of the maintenance of a record of all transactions, or bookkeeping, as it was called then. Since that time the accumulated experience and ideas of many people have been made a printed record. Through a review of several of our modern reference books, a person now can obtain information respecting the principles underlying the practice of accounting which it took many of us years to learn through an attempt to solve problems which arose in our day-to-day work. Some of our solutions were not in accord with what today is considered the best practice.

In accordance with our present theories of education and living, we are attempting to make everything as easy as possible for the younger generation. In talking to a large number of boys who have majored in accounting in several of our Midwestern universities, and who graduate this June, I asked many of them what books on accounting they had read. With very few exceptions I found that their reading had been restricted to one or two books for each accounting course which they had taken. I cite this as an illustration of the present trend to concentrate the information which is placed before the younger generation for their knowledge and training, and not as a criticism of our schools of business administration. I also found, as I have found over a period of years, that the boys were very ignorant as to the basic principles underlying the practice of accounting, such as the evidence of transactions before a record can be made, the real nature of a profit and loss statement and a balance sheet. Practically all could very glibly give me the rules as to what items should be included as current assets, etc. They could not, however, tell me the why.

If there is a need for a comprehensive statement of the principles underlying the practice of accounting other than the very complete statement as set forth in the numerous books which have been written and in published articles, I would say one reason for such a statement would be to permit our educational institutions to make it easier for the students to obtain a sound knowledge of at least all of the basic principles.

In recent years, the practice of accounting has become of great importance to the majority of the people of the country. A very large number of people are direct investors in one or more corporations and receive at periodic intervals financial statements disclosing more or less information as to the operations of the companies. Many more have an indirect interest through life insurance companies, savings and commercial banks and other institutions. Many people follow the financial pages of our papers and financial journals in which information respecting the operation and condition of many companies is discussed. A large majority of these people have a scant knowledge of the principles underlying the practice of accounting and are unable to draw accurate conclusions from the information which they receive. If a statement could be prepared to educate the rank and file of the people as to principles of accounting, and if attention were paid to such a statement, there would be a great need for the development of such a statement.

There is a third class of people composed of those actively engaged in manufacturing, mercantile and financial activities, and also including members of the bar and governmental officials, who should be conversant with accounting principles but too frequently are not informed. There is, I believe, a great need for a simple statement setting forth the basic principles underlying the practice of accounting to be used for the information of this class.

If there is need for such unified and coordinated effort^ who should exert such unified and coordinated effort?

It is my belief that a careful study of several of the recognized texts on accounting will furnish students in our schools of business administration a knowledge of the principles underlying the practice of accounting. If, however, those who are actively engaged in educational work believe, as a result of their experience, that the text material is inadequate or requires too much digging or research on the part of the students, I believe that there should be on the part of those engaged in educational activities a unified and coordinated effort to prepare the proper text material for use in our schools. There should, of course, be cooperation and collaboration between educators and committees of the American Institute of Accountants and the various State Societies of Certified Public Accountants.

As to the rank and file of the people, I am rather pessimistic as *to* whether any statement respecting the principles underlying the practice of accounting can be prepared which will be studied and read by them, thus placing them in a better position to understand financial statements and reports.

Many of the younger attorneys are taking accounting courses in our night schools. This is also^ true of many of the younger men *in* banks and other financial institutions. In order for those persons to obtain a knowledge of accounting principles, they are required to spend much time on matters of the technique of preparing statements and other similar matters. It is my opinion that there should be a united and coordinated effort between accountants in active practice and our educators to develop a statement of the principles underlying the practice of accounting for the use of those persons who wish to be fully informed as to the basic principles and the application of those principles to the usual set of circumstances, but who have no desire to actively engage in accounting activities.

There have been suggestions that governmental agencies should prepare a statement of accounting principles for the guidance of business enterprises, particularly corporations, and accountants engaged in public practice. Such statements have been prepared in the past for those enterprises which are subject to governmental regulation—for instance, railroads, utilities, banks, and insurance companies. The accounting principles set forth in such statements have been largely based upon the regulatory laws, and to quite an extent have been at variance with accounting principles generally accepted for use of enterprises which are not subject to close governmental supervision.

In considering the question as to whether a statement of accounting principles should be developed by governmental agencies, I believe a more fundamental question should be raised—as to the proper functions of the Government. Under any system of planned economy under a dictatorship, governmental agencies must, of course, prescribe not only principles but numerous rules and regulations. Under a system of free enterprise, however, it is my belief that governmental agencies should have only such voice in the development of a statement of accounting principles as is necessary under the police powers of the Government. In considering whether this is a practical viewpoint, I wish to direct your attention to the problem of preparing and enacting Federal and state legislation which would cover all principles and procedures relating to the practice of accounting.

If there is need for a statement of the frincifles underlying the practice of accounting, how extensive or detailed should such a statement be?

Before considering this phase of the question, let us consider other professions for a few minutes. Have other professions found it necessary or advisable to prepare statements of the principles underlying the practice of such professions? I believe that very early in the training of mechanical engineers they learn a few basic principles of mechanics, and that all mechanical processes involve the use of one or more of the basic principles. They also learn that these basic principles have been known and understood almost as long as we have any record of the human race. These principles include those involving the wedge, lever, screw, gear, pulley, cam, and possibly two or three others. Not being a mechanical engineer, I am not attempting to discuss this subject, but cite those basic mechanical devices for illustrative purposes only. Thousands of volumes have been written respecting the application and extension of those basic principles. Similar illustrations could, I believe, be cited respecting the principles underlying the practice of other professions. The real problem involved in the preparation of a statement of the principles underlying the practice of any profession is the problem of determining the extent to which basic principles should be expanded. In the expansion of the basic principles, we, as accountants, of course meet with the problem of determining whether certain conventions constitute principles or whether they constitute procedures used *in* the application of principles to specific transactions.

As will be seen from my previous comments, it is my thought that any statement of accounting principles prepared through the unified and coordinated effort of practicing accountants and educators should be prepared largely for the benefit of those persons who are not following accounting as a profession. From time to time, writers have endeavored to prepare statements of principles, procedures, and practice respecting the other professions for use and information of the public. I refer you to numerous publications, having titles such as "Law for the Layman," "Every Man His Own Doctor," and legal questions and answers in our newspapers, health columns in our newspapers, *et cetera.*

It is my feeling that any attempt to prepare a statement of the principles underlying the practice of accounting which would be construed by the readers to be more than a statement of the more basic principles would have disastrous results. There is a very old saying—"A little knowledge is a dangerous thing." Most of our criticisms of accounting principles and accounting practice have, I believe, arisen from the fact that too many persons have a smattering of accounting knowledge, but believe themselves fully capable of drawing conclusions respecting accountants' reports, and also from the fact that many erroneous conclusions have been drawn because of the failure of too many people to read exactly what the texts of the reports, the statements and the footnotes disclose.

Those of us who have been trained as accountants know the limitations of financial statements, and realize that such statements, even though accompanied by elaborate footnotes or auditors comments, are summaries only, and look upon them as such. When we see that an enterprise has no accumulation of cash with which to pay dividends, although the operations have resulted *in* profits, we make studies and seek additional information to learn why. One of our greatest problems is the preparation of statements which will be as informative as possible within the limitation of summary statements. We also realize that any statement of the profits of a business enterprise is more or less of an estimate. Much of the criticism of accounting practices is, I believe, due to a misconception of the limitations of financial statements. That is a subject which should, I believe, be set forth clearly in any statement of accounting principles.

// a statement of the frincifles underlying the fractice of accounting is develofed) will such a statement have any lasting value or will It become obsolete as soon as it is develofed?

In the early part of my discussion, I stated what I believe to be the basic principles underlying the practice of accounting. Those basic principles have existed without change for many years, and I see no more possibility that those basic principles will be changed or become obsolete than that the law of gravity will become obsolete. The supplemental principles expanding the basic principles are, of course, subject to constant change. The classifications used in summarizing and classifying the transactions are very much different today than they were twenty-five or more years ago. Do you remember the old merchandise account, to which were charged the inventory, purchases and expenses, and to which sales were credited? Do you remember the old interest and discount account, which included interest income, interest expense, cash discounts earned and cash discounts allowed? If you will refer to some of the early writers, you will find that such accounts were considered proper. If you will refer to some of the early volumes showing C.P.A. problem solutions, you will find that the order of items in the financial statements was not in accordance with our present-day practice. While there has been no change in the principle that an accountant's report should, among other things, describe what he has examined, the scope of his examination, and his opinion respecting the statements submitted as a part of his report, the phraseology used today is very much different from that used even as recently as ten years ago.

I believe that you will agree with my conclusion that a comprehensive statement of all of the principles underlying the practice of accounting would contain many statements which would be subject to change and modification constantly. Many modifications would be required, I believe, over a period of years. Let me cite the change which has occurred during the past ten years in the viewpoint of accountants as to whether projected statements are proper. A few years ago, an accountant was subject to criticism if he prepared projected statements. At the present time, however, the preparation of such statements is considered a proper function of accountants. A resolution of the Council of the American Institute of Accountants in 1932 recognized the propriety of accountants assisting in the preparation of estimates regarding the results of future transactions. That resolution and also some of our present-day practices respecting budgets and statements of reasonable expectancy have, in all probability, caused many of our predecessors to turn over in their graves. A careful review of many of our present-day practices and their comparison with recognized principles of accounting practice a few years ago would, I believe, prove conclusively that the principles underlying the practice of accounting, particularly those relating to the classification and summarization of transactions, are being changed constantly. I believe that this statement is equally applicable to other professions.

// a statement of the principles underlying the practice of accounting is developed, what provision could be made to settle differences of opinion respecting such principles?

I am not attempting to answer this question. It is raised to bring before you the fact that there are differences of opinion, and if the practice of accounting continues as a profession, differences must exist. Recently, there was a series of letters and articles published in the *Journal of Accountancy* respecting the treatment of the amount by which the proceeds from the sale of treasury stock exceeded the cost thereof. Lest I be involved in any controversy at this time, you will note that I have not used the word "profit" from the sale of treasury stock. The chief accountant for the Securities and Exchange Commission has issued an opinion respecting that matter. Volumes have been written respecting the proper treatment of depreciation. There have been many discussions regarding the method of amortizing patents, and whether in some cases patents are subject to amortization. There are many problems which have arisen and will arise in connection with the classification of transactions, and the reflection of such transactions in the financial statements because of decisions of Federal and State Courts.

// such a statement is developed and could he adopted^ what means could he provided to enforce the provisions of the statement?

I not only decline to attempt to answer this question, but I shall not even discuss it. It is a question, however, which should, I believe, be given careful consideration in connection with any attempt to develop a somewhat detailed statement of the principles underlying the practice of accounting.

Is the practice of accounting a profession?

The practice of accounting has been recognized as a profession and is so recognized at the present time. For the sake of argument let us agree that such recognition is proper, and that the practice of accounting is a profession.

Will the practice of accounting remain a profession if such practice must he in accordance with a statement of principles unless such a statement is general in its nature?

If it were possible to prepare a detailed and comprehensive statement of principles which would include all of the rules respecting the recording of transactions, the classification and summarization of transactions, and the reflection of such transactions in summary statements, a person practicing accounting would no longer be required to use any judgment to determine how such transactions should be recorded, classified, and reported. All that would be necessary for a practitioner to do would be to follow the rules. Judgment no longer would be required *on* the part of the practitioner. I believe that you will agree with me in the conclusion that the practice of accounting no longer will be a profession if the time arrives when it is possible to have all principles stated in the form of rules of procedure.

CONCLUSION

In conclusion, let me summarize briefly. It is my opinion that:

(1) There is no necessity for the preparation of a statement of the principles underlying the practice of accounting for the use of those persons who are making an intensive study of accounting, in order to fit themselves to enter the profession, and those persons who are engaged in the practice of accounting.

(2) Many people who are not accountants and do not intend to practice accounting should be informed as to the principles underlying the practice of accounting. For the benefit of those persons, there should be an authoritative statement of accounting principles. Such a statement should be developed by educators and persons active in the practice of accounting.

(3) The statement of principles underlying the practice of accounting should be general in its nature. No attempt should be made to have such a statement contain any more detailed information than is necessarily required to *give* the reader a working knowledge of the more important principles underlying the practice of accounting, in order to permit him to draw reasonably accurate conclusions respecting financial statements.

CHAIRMAN DAI/TON: Thank you, Mr. Torbet.

The subject this morning has been divided into two divisions, and we will suspend any discussion of the papers until the second speaker has concluded his address.

Our second speaker this morning is the head of the Division of Accounting of the University of Iowa. He holds a C.P.A. certificate from the states of Illinois and Iowa; he is a member of the American Institute of Accountants, a member of the Honorary Society of Beta Gamma Sigma and Beta Alpha Psi and other honorary academic societies. He is now President of the American Accounting Association.

It is a privilege to present to you Professor S. G. Winter, of the University of Iowa.

THE NEED FOR UNIFORM AND COORDINATED EFFORT IN THE DEVELOPMENT OF A STATEMENT OF THE PRINCIPLES UNDERLYING THE PRACTICE OF ACCOUNTING

By SIDNEY G. WINTER, C.P.A.
Professor of Accounting, University of Iozva, Iowa City, Iowa, and President, American Accounting Association

Mr. Chairman, I believe you will agree, and I think that our audience will agree, that Mr. Torbet and I did not write these papers while we were sitting at the same desk where we could discuss this matter. On the other hand, I would like to have you pay rather close attention to the points on which we agree rather than to worry much about the ones on which we may disagree.

My paper is relatively brief. I thought that I might take a little time to put in a plug or two for the American Accounting Association, but I guess I shall not take advantage of the hospitality of the University to do that. I will just put it this way—If you find anything in these few remarks with which you can agree, then I am speaking as President of the American Accounting Association; if not, then it is just a fellow member of the Institute, or just another old college professor.

One need scarcely remind a group of this sort that during the past two or three years there has been an interest, partly new and partly revived, in the discussion of "accounting principles," nor that this interest has been suiBciently intense and sufficiently widespread to warrant the assumption that the desirability of our acknowledging a comprehensive set of "governing forces" has been generally recognized throughout the accounting profession. Probably too much time, and time is ever valuable, has already been *given* over to attempting to fix the name which should be assigned to these "forces"—accounting laws, accounting rules, accounting principles, accounting standards. In my judgment, we may do our original thinking with any of these terms in mind and, if the attention is kept accurately in focus on the major problem, progress can be made.

I would not assert that these terms—laws, rules, principles, and standards—are synonymous or that they are equally well suited to our purpose. I suggest merely that we would do well to cease launching attacks on words at this point in the game and get on with the business of examining the substance of the problem. Accounting may or may not have a "law" which is a blood relative of the "law of gravitation," a "rule" which is analagous to a "rule of evidence," a "principle" which is like one of the "principles of theoretical mechanics," or a "standard" functioning as does a "standard gauge" or a "standard time." Accounting most obviously does need something under the terms of which those of us who are classified as "skilled" may explain to those of us who are classified as "laymen" just what is meant by those few little words, "generally accepted accounting principles consistently applied during the period under review." Unless we soon get some specific uniformity in the answers supplied by the *skilled,* grave doubts may begin to arise in the minds of the *unskilled*—they may go so far as to assume that their own judgments and decisions are no farther afield than is the miscellaneous assortment' supplied by the *skilled.*

It would be relatively easy for me to spend my time this morning examining the possible meanings which might be attributed to the ten major words in the subject assigned to me. If that did not suffice, I might examine the possible combinations of the possible meanings examined earlier. If I were still honored by your presence, I might examine some of the procedures possible under the possible combinations of these possible meanings, and then, as a climax, the results which one might regard as possible of attainment.

Along these lines I believe you have little to fear. I shall deal little with alternatives. Briefly, let me state my understanding of certain words and indicate the sense in which I propose to use them. *Need* is such a common experience, even among accountants, that the word *needs* no elaboration. *Uniform* means like or similar—not without variations but with only unimportant differences, uniform as in the expression, "a uniform climate." *Coordinated* indicates placement in the same rank or with the same power—harmonious, intended to insure the cooperation of all essential parts or parties. By *effort* I assume that there is recognition of the fact that there will be a place in the scheme for work. *Developnent* brings to mind gradual evolution, and here we might stress in some measure the significance of the term in the biological sciences, the series of changes by which an organism passes from a lower to a higher state. A *statement* is here a formal summary of facts or contentions. In my definition of *frincifles* I hope to avoid being in even the slightest degree dogmatic. A *frincifle* is a general truth or proposition, a settled law or rule of action. For our present purposes I am inclined to favor the last part of this, and to emphasize the words, *rule of action. Underlying* will be regarded as fundamental, or essential to, or controlling. In the words, *fractice of accounting,* I see both the preparation and the customary uses of financial statements prepared by professional accountants. It might be contended that practice should be limited to preparation, but preparation without due regard for the uses to which the prepared statement will or may be put is, in my judgment, inexcusable.

You may feel that I am already inconsistent. I have in some small measure decried the launching of attacks on words, and then quite calmly proceeded to set out a row of words which may well invite attack. Words are, however, important; not so important as ideas, but essential to the conveying of ideas in an undertaking of this sort. I have tried to outline our ordinary understanding of these words.

In the development of accounting there are several parties at interest. The accountant himself is probably no more important than is any one of the others: The government, investors, credit grantors, management, the client-business man, even teachers of accounting. Each of these has a stake in the final product. Each may find himself in a dual role, possessed of more than a single interest; the client may be a manager, the credit grantor may be a manager, some teachers are practitioners, and there may be teachers who are actually investors. Certainly it is presumed that all are represented in the government. Each of these groups may have ideas as to what the development of accounting should encompass and as to the procedures which should be followed.

Because of the demonstrable interests of widely separated groups, because of the variety of uses to which accounting statements may be put, because it seems unlikely that any one group could well compose a set of rules or principles which would serve adequately and equitably the needs of all groups, I am most willing to support the thesis that there is need for uniform and coordinated effort in the development of a statement of the principles underlying the practice of accounting. A major task is that of determining just what means are available to accomplish the end in view, and, if there are several, which is to be preferred. It is to this part of the problem that I wish to devote some attention.

I believe it is generally conceded that there is need for a summary of the fundamentals of accounting, a summary backed by a maximum of authority. It would seem that, in the developing of this summary, the views of all parties at interest should receive consideration commensurate with the various degrees of interest of such parties. There is little gained by making rules for a game if no one, save the maker of the rules, is willing to play the game under the rules thus devised. If we can bring to the task the uniform and coordinated efforts of the parties at interest, the results are much more likely to be enduring. It behooves us then to find a plan under which uniform and coordinated effort may be obtained.

There are several ways in which a statement of principles may be developed. The simplest is, probably, the issuing of a set of "regulations" by the Federal government. A second is a pronouncement by an organization such as the American Institute of Accountants. A third is to be found if we make use of a committee composed of representatives from the government, the professional accounting societies, the educators, and such organizations as the bar, the bankers, and the commercial credit grantors. A possible fourth would provide for the selection of a czar, who would serve accounting as other czars serve baseball and the motion picture industry. To each and all of these there are manifest objections. Let me consider some of them briefly. I doubt that I can suggest in these few moments any objections which have not already occurred to you.

To date, I have heard relatively little hue and cry imploring the Congress to direct some Federal bureau to issue a statement of accounting principles. On the other hand, we have all heard of late something to the effect that the accountants should prepare something along this line before the Federal government does it for them. I hope that this spur will not precipitate us into ill-considered action. The objections to governmental interference are too obvious to require setting forth at this time.

The objections to the issuing of pronouncements by an organization such as the American Institute of Accountants may not be so wholly obvious. Nevertheless, they seem to exist. Of necessity, the Institute must represent primarily the accounting practitioner. To this extent its pronouncements are biased. I do not overlook the fact that individual members of the Institute, as individuals, may be most willing and most able to render most helpful service to the government, to bankers, to investors, or to any other group, in a limited and reasonably objective way, but I cannot imagine these same individuals representing the Institute without regarding most subjectively the welfare of the accounting profession which the Institute is incorporated to represent. Those who from time to time direct the affairs and express the attitudes of this organization may in many instances view matters with considerable objectivity and from long range, but they are handicapped in that they must respond in greater or lesser degree to the opinions of the rank and file, opinions of those inclined to view with some alarm any proposals which apparently threaten to disturb established procedures. Probably the greatest misfortune in this connection is the tendency to glorify practice—to contend that what *is* must be good because it *is*\ It is not unlike the contention that the king can do no wrong. And just as sensible! It would seem that neither the public nor the regulatory authorities are going to have any patience with this type of approach.

But these are not the only objections to pronouncements from such a source. There are other and similar sources which may well follow suit by issuing pronouncements more satisfactory to themselves. Insurance companies and other large purchasers of securities may issue a statement of the accounting principals to be observed in the preparation of financial statements of companies whose securities are offered as investments. The National Association of Credit Men might devise its statement of acceptable principles. Each would, of course, tend to emphasize those "principles" the observance of which would result in greatest benefit to the group compiling the summary. Each, in other words, would have a special interest. The greatest single handicap of the professional accountant in these matters, even if he is able to convince the public that he has neither a personal nor a collective axe to grind, is the improbability of his thinking objectively and acting objectively while the client, particularly the important client, is peeping over his shoulder. To get over this hurdle is, as I see it, the first task of those charged with the responsibility of inaugurating the recently announced research activity of the Institute.

The development of a statement under the auspices of a committee representative of all or of nearly all of the parties at interest would gain something *in* objectivity, but would probably reflect chiefly the viewpoints of the one or two strongest personalities in the committee. Progress would be slow. The work of the committee would unquestionably have to be ratified by the respective groups represented. And, ratification may be greatly delayed despite the willingness of a majority of the individual association members to abide the decision of the committee. Witness, in 1939? one state's ratification of the action of its representatives in connection with the adoption of the Constitution of the United States.

Very obviously, the introduction of a czar would bring special problems into the already crowded field. Accounting problems are not so concentrated as are those of baseball management. They may be even more numerous and varied than those attending the operation of the motion picture industry. In the eyes of some the czar would be "an old reactionary," while others would view him as something of a "revolutionary." Both terms are currently *in* disrepute in this section or that, and I feel that the czar would not stand up under the cross-fire. I think we need give no further thought to the development of a statement of accounting principles under a czar, and this, regardless of the sponsorship under which his highness might come originally to the throne.

There is one avenue of approach which we have not investigated, and it is the one which, to me, offers the greatest probability of our reaching a satisfactory solution of the problem. Accounting as a profession is new, very new. Despite its remarkable progress, a progress which I would be among the last to gainsay, it still has a great deal to learn. Only in a measure has it attained professional status. True, it has for some years laid claim to professional status, but I might name several far less prepossessing groups which have done even more along this particular line. Professional standing comes not so much as a result of claims as it does from works of such character that professional standing is conceded by the public. One of the tributes paid by the public is recognition of the fact that the subject matter in the field of the group in question deserves a place in the higher educational program, which the public, through gift or taxation, supports. We are unquestionably familiar with other professional hallmarks, but this appears to be the one most intimately associated with the solution of our present problem.

The development of a statement of accounting principles is a part of the educational process. It would seem to follow, therefore, that, in the development of accounting as a learned profession, increasing attention must be given to the philosophical and theoretical bases of its practices. Those best qualified to guide this development would appear to be those whose first interest is in research and education in the field. You may agree with me that the profession has shown some tendency to recognize this fact. The Statement of Accounting Principles prepared for the Haskins and Sells Foundation, and issued by the American Institute of Accountants, was prepared by three educators—Messrs. Sanders, Hatfield, and Moore. To head the Institute's research activities, not a practicing accountant, but a teacher, Professor Sanders, has been selected. You will find increasing recognition of educators on committees of the Institute, on accounting committees of other organizations, and in the various state societies. Some have served as members of state boards of accountancy.

It might be well for us to inquire into the reasons behind this recognition of the educator by the profession. It may well have started chiefly as a matter of "keeping up with the Joneses." In law and in medicine, professions with which we are wont to compare ourselves, educators participate actively with practitioners. There may be the hope or belief that the educator can contribute some idea of immediate value to the practitioner. More probably, there is a feeling that the educator may bring to an assault on the problems of the profession a strength which is inherent in his detached point of view, his objectivity, his "knowledge of forests without too immediate concern for a given tree." It may or may not be that the presence of educators lends some touch of dignity or professional respectability to the proceedings. (Personally, I could never hope to appear so dignified nor so complacent as do some practitioners I have known!) I think there is no denying the fact that, in the eyes of the public, the educator generally contributes a wholesome impartiality, a long-range point of view, and a minimum or lack of ulterior motive not usually accorded to others. I have attempted to cite these few points merely as possibilities. I may have overlooked some important factors. But of the truth of this next statement there can be no doubt. An educator may openly become a special pleader for any group and retain, in other matters, his standing as an impartial observer, but the educator who is guilty of becoming a special pleader while posing as an academician loses not only his impartial standing but the respect of his colleagues.

A satisfactory statement of accounting principles is not something which will spring full-blown from the brow of any Jove. It will evolve slowly as a result of the exchanging of ideas, the considering of contentions, the attempted reduction of ideas to words, the reconsideration of both the ideas and the words used to express the ideas. The initial effort must be directed towards the discovering of a pattern generally applicable to all accounting expression. Gradually, thereafter, the individual pieces may be brought into agreement with the governing scheme. One does not learn architecture by studying doors, chimneys, sidewalls and miscellaneous odds and ends. One learns first the general principles which control materials, lighting, heating, ventilating, design, and other fundamentals. In like manner, we, as accountants, probably waste our time in discussing the principles which govern the accounting for any specific asset until we have discovered the principles which govern all assets. We may rest assured that such principles, if they exist, will be discovered, and this, whether or not we happen to like the form or content finally revealed.

I am not unaware of the fact that we have some, probably too many, members in our professional group who feel that the active practitioners in the field should be sufficient unto themselves. They are inclined to resent the introduction of supposedly "theoretical" and "radical" ideas advanced by teachers and writers as unwarranted intrusion in a field preempted by members of public accounting firms. This attitude betrays a lack of appreciation of the necessary basis for existence of any profession which is not merely an active practice but a practice supported by scientific knowledge and accepted principles. Fortunately for the profession, such members appear to be in a gradually diminishing minority.

May I submit for your consideration then, these thoughts:

(1) That the development of accounting principles must begin with

a search for the philosophical and theoretical bases underlying accounting practice, and not with the granting of some official blessing to sanctify what *has* been done as what *should* be done;

(2) That this development should be to an increasing extent under the direction of those whose primary interest is in research and educational work in the field;

(3) That all parties at interest—practitioners, teachers, users of financial statements, and the regulatory authorities—should cooperate fully in the undertaking;

(4) That uniform and coordinated effort is more likely to be secured under educational direction than under that of any other group;

(5) That the end product resulting from development along these lines will be superior to that resulting from the work of any group alone or from any other method of cooperation.

DISCUSSION

CHAIRMAN DALTON: Thank you, Professor Winter.

Your Chairman was not advised by the Program Committee as to the opposite position that the speakers were going to take on this subj ect this morning, but I gather from what has been said that it must be their wish that the opposite positions would invoke some discussion from the floor. We have a few minutes left and I now would like to open the meeting for some discussion from the floor or for some questions that you might care to ask either one of the speakers.

A VOICE: I would like to ask Professor Winter if he does not think he made a pretty good plug for his Association.

PROFESSOR WINTER: Thank you very much.

CHAIRMAN DALTON: I feel sure that there are opposing views in the audience if anyone cares to express them. The opposing positions of these two papers presented this morning, concerning the need for a uniform and coordinated effort in the development of the principles underlying the practice of accounting, are open to discussion.

Might I ask, Mr. Torbet, if in the absence of a coordinated effort in bringing about some underlying principles you entertain any fear as to governmental agencies prescribing rules that may be contrary to some of our fundamental thinking?

MR. TORBET: Well, in the first place, your question assumes a fact which I do not admit: That there is an absence of a coordinated effort in the development and statement of accounting principles.

If there were no such statement and if there were no such effort being exerted at the present time and having been exerted over a long period of time, it might be very fitting for some governmental agency to do something along the line of developing accounting principles. But in order to do that, we must change our form of government, even much more so than has been done during the past few years.

For instance, what right has the Federal Government to direct the activities of any profession? Now they can do it indirectly through regulating the sale of securities and regulating the trading of securities on exchanges, and requiring such companies to furnish statements that contain certain information. However, the Securities and Exchange Commission, or any other commission, has no more powers than are given to it by legislation, and the Supreme Court in the N.R.A. case held very definitely (and it was one of our few unanimous decisions in the last few years) that Congress could not delegate any legislative power to the President or to any commission. Now, the matter of directing and setting forth accounting principles by a commission would be a matter of legislation, as I see it.

Now, the Securities and Exchange Commission has a right to administer a regulatory law and, so doing, it has certain powers granted to it by the Securities Act and the Stock Exchange Regulation Act. One of those powers is that statements must be certified, and these statements must have a certain minimum information and be in a form which may be prescribed by the Commission.

Now there, in deciding as to the information that will be set forth or the form in which the information will be set forth, they have ruled on several points, one of which is that the so-called profit from the sale of capital stock becomes capital surplus—it becomes surplus of the same nature as paid-in surplus. However, I think if they attempted to enforce that decision in the State of Illinois, and some of our other states, our state courts would absolutely overrule them because our Illinois Corporation Act has a very decided definition of what paid-in surplus is. If you sell stock at a premium, that premium becomes stated capital, and that is what we usually call capital surplus or paid-in surplus. Now, that is a category of surplus entirely different from any surplus received from the sale of treasury stock for more than you had to pay for it. Now, if you try to combine those two things in the report of an Illinois corporation, why, I do not think the courts would uphold it, even though the S.E.C. says you must do something of that sort.

CHAIRMAN DALTON: In the meantime, those rules of accounting procedure *or* practice more or less prevail as far as—

MR. TORBET: They prevail, but what the S.E.C. has done in those decisions—all except this treasury stock decision, I think—has been merely to state for the information of the public at large and the accounting profession certain principles which have been recognized for a great many years. For instance, its requirement on the matter of the content of a certificate or the accountant's opinion—it has not been stated in just so many words, but that was a fundamental rule that has been in existence almost as long as I can remember. I think you will find, not similar phraseology, but that same thought expressed in Montgomery's original text. That is going back to ancient history. Other points that they have announced are old basic principles.

CHAIRMAN DALTON: Are there any other questions from the floor?

QUESTION: Mr. Chairman, I would like to ask the speakers, or either of them, what their reactions were as to the adequacy, etc., of the Haskins & Sells combination-statement of accounting principles?

CHAIRMAN DALTON: YOU wish to direct your question to any specific speaker?

QUESTION: TO either speaker, or I will be glad to hear from both of them.

PROFESSOR WINTER: I will take a chance on that; I am always in jeopardy.

I have, back here two or three paragraphs, made this statement: If we can not get some substantial uniformity in the answers which professional accountants give to certain questions, somebody is going to get the notion that, after all, they have been paying for a lot of stuff that maybe was not worth much. If you can do this or do that or do the other thing, or if you do not feel like that, jump out the window, if almost anything is legitimate—I have almost reached the conclusion that we would be dubbed as second guessers, that we want to have plenty of leeway, plenty of openings.

I will put it this way, I am sorry that that statement did not make some effort to give us what you might call a definitive statement of accounting; that is, what is accounting and how are we going to go about doing something with it? Now, I just toss this out for your consideration—by definition you could say that accounting is a discipline of some sort which has for its purpose this: The recording of costs; the allocating of those costs over a useful life. As that allocating of cost over a useful life goes on, you attempt to match against those costs revenues which have come into the business. If you have more revenues than costs in this matching, you have income; if you have more costs than revenues, you have lost something. That is accounting.

Perhaps you do not like that. I am not asking you to like it. I am telling you that it is what I think accounting necessarily is. I am merely attempting to illustrate a position. If accounting does this, the public, when it picks up an auditor's statement, can say this accountant—a man who is reliable, in whom we have confidence—has verified and examined, has satisfied himself that these things shown as balance sheet debits are original costs, or what is left of them; what has not been amortized or allocated Into something else; this accountant has attempted to match all the "takes" in this year with all the "puts" and has reached the conclusion that, "puts" exceeding "takes," there has been a loss. If we could get some definition of what accounting is supposed to do and then some limited statement of the responsibility of a man who says, "This has been done," 1 think we have a point of departure, and we could go to town and we could go in a big way.

Now, let me repeat, I am not saying that I am ready to say at this moment that that is what accounting must do, no more and no less, but I am perfectly willing to hazard this: You will agree with me, for example, that we should not be expected to appraise inventories. Did you ever count diamonds in the audit of a jewelry store? I am not sure I did. I have counted a lot of stuff, a test check there to see that they had so many stones and they looked about the right size. Of course, they might have been cut out of the top of a Budweiser bottle, I do not know. (Laughter.) I am safe there. You do not want to join me in appraising inventories, I am sure.

Now, to that extent I am a little sorry that the Haskins and Sells report, that statement of accounting principles distributed by the Institute, did not attempt to give us a little more accurate picture, rather than to say that nineteen firms can do this and eighteen firms do that. I am not condemning either of those groups of firms for having done one thing or the other, but I am very suspicious of what the public is going to think. It is more than a suspicion; I am rather convinced of what the public is going to think if we try to excuse too many peculiarities through the use of a miscellaneous assortment of alternatives.

Now, as I say, I am probably more in jeopardy than I was before.

CHAIRMAN DALTON: Are there any other questions?

In keeping with what has been said in regard to the adoption or development of uniform accounting principles, within the last six months there has come over the horizon a new problem with which we are going to be confronted, and that is the adoption of extended, normal auditing procedures which is an outgrowth of the McKesson-Robbins case. So probably the next time we have a meeting, you will be hearing a great deal concerning the newly adopted resolution of the auditing procedure committee of the American Institute, which worked in conjunction with the S.E.C., Robert Morris Associates, National Credit Men's Association, New York Stock Exchange, and so forth, in which they have designated as normal procedure certain extensions of what heretofore had not been considered normal procedure. That report will probably bring forth the same controversial discussions that we have had in regard to underlying principles.

If there are no further questions from the floor, at this time I would like to express our appreciation to both speakers on this morning's session for coming here and delivering these very excellent addresses. Both of you are busy men, and the preparation required sacrifice of your time and thought, and we wish to express our acknowledgement thereof.

SECOND SESSION

FRIDAY, MAY 19, 1939—2:00 P.M.

The Faculty Club

Address: "A Humorist's Slant on Current Events"

DR. FELIX E. HELD, *Professor of Economics and Business Organization, The Ohio State University*

(Dr. Held gave an entertaining and instructive address on current developments in government, business and politics. He emphasized the need for the appraisal of current problems of both business and government on that kind of factual basis with which accountants are accustomed to deal.)

THIRD SESSION

FRIDAY, MAY 19, 1939—2:00 P.M.

Chairman:

THE HON. THOMAS J. HERBERT, *Attorney General of Ohio*

Topic: Some Problems Common to the Practice of Law and Accounting

Papers:

LIONEL P. KRISTELLER, *Attorney-at-Law, Newark, New Jersey; Chairman of Insurance Section of The American Bar Association*

F. P. BYERLY, *C.P.A.y Member, Price, Waterhouse and Comfany, New York, N. Y.; Chairman of the Committee on Cooperation with The American Bar Association of the American Institute of Accountants*

OPENING OF SESSION

By GEORGE W. ECKEIJBERRY, C.P.A.
Professor of Accounting) The Ohio State University

May we come to order please?

This Institute is especially fortunate in having as its presiding officer this afternoon one who in his private practice of law and in his official capacity has had an opportunity to deal with problems that involve the use of law and the use of accounting. The Attorney General of Ohio, the Honorable Thomas J. Herbert, for a number of years was Assistant Attorney General assigned to the work of the Public Utilities Commission. In that office he represented the Commission in many cases before the Supreme Court of Ohio, and the Supreme Court of the United States. Many of these cases involved large questions of accounting. I think the State of Ohio is particularly fortunate in having a man of this type as its Attorney General today.

We are indeed fortunate in having Mr. Herbert with us to preside over this particular session, and we are very grateful to him for being with us. He has taken time away from his office, and he has, at considerable personal inconvenience, kept his date with us today.

I am very proud and happy on this occasion to present to you as the presiding officer the Honorable Thomas J. Herbert, Attorney General of Ohio.

INTRODUCTORY REMARKS

By THE HONORABLE THOMAS J. HERBERT
Attorney General of Ohio

I am very glad of the opportunity to come here and preside at your afternoon session today. I appreciate the honor and the courtesy that was extended to me in that respect. I particularly appreciate the close relationship of the Bar and the profession of accountancy, not only over Ohio, but all over the country, because it seems to me that, the further we go in our industrial and, in fact, every phase of our social development, we find ourselves necessarily leaning more and more upon accountants. I have even found several accountants, who are friends of mine, who admit that there are times when they must lean on a lawyer now and then. So it seems to me that the purpose of this Institute is certainly well carried on in the topic which you have established for the afternoon session today.

I may say that I came down here in a considerable hurry, very much afraid that I would not get here in time for the opening, as I had to attend an installation of the new Court of Appeals Judge in Cleveland this morning, which necessitated my operating on a rather short schedule. But the only regret that I seem to have left out of it now is that I was not able to come down in time to attend the luncheon and to enjoy that, as I understand that it was a very delightful meeting.

Now, in this afternoon's session, the topic is "Some Problems Common to the Practice of Law and Accounting," and the first gentleman who will address you on that subject is certainly well qualified from the law side *in* a discussion of that nature. Mr. Kristeller was admitted to the practice of law in 1914, and is in active practice in Newark and in New York City. He has served as a Supreme Court Commissioner and Special Master in Chancery for the State of New Jersey. He is Chairman of the New Jersey Bar Association Committee on Ethics and Grievances, and he is also the Chairman of the American Bar Association's Committee on Insurance. The last Committee that I mentioned has been very active in studying the modern practice of law in relation to insurance, and in relation to accounting also.

I want to introduce to you now Mr. Lionel P. Kristeller, Attorney-at-Law, from Newark, New Jersey. (Applause.)

SOME PROBLEMS COMMON TO THE PRACTICE OF LAW AND ACCOUNTING

By LIONEL P. KRISTELLER
Attorney-at-Law, Newark, New Jersey, and
Chairman of the Insurance Law Section of the American Bar Association

Your kind invitation to address you on behalf of the Legal Profession on "Some Problems Common to the Practice of Law and Accounting" is sincerely appreciated, and I hope that I shall not wander too far from the suggested topic. I shall try to present my views with respect to the position frequently taken by members of my profession that there is an ever-growing encroachment upon the practice of the law by those who are not members of the profession. This criticism is not leveled at accountants alone, but applies with equal force to real estate agents and brokers, corporate fiduciaries, peace officers in rural communities, lay insurance adjusters, collection agencies, and others. At the outset let me make it clear that the views expressed during this discussion are personal to me, and are not those of any organized Bar, or of any association of lawyers, except in those instances where I especially refer to definite concerted actions or specific resolutions. Some of my views on this subject of encroachment may be unorthodox, for I never have been able to convince myself that it amounts to an evil warranting the vindictiveness exhibited by many of *my* colleagues at the Bar,

Last year, as Vice-Chairman of the Insurance Law Section of the American Bar Association, I had the opportunity of meeting with members of the Committee on the Unauthorized Practice of the Law of the American Bar Association in session with representatives of insurance and utility interests, in an effort to arrive at an amicable solution of alleged encroachments, or the apparent encroachment of lay insurance adjusters, and adjusters for public utility companies in the settlement of tort claims and other insured interests. The conflict between the Bar and the insurance and utility interests is in all respects similar to the conflict between real estate agents and brokers, corporate fiduciaries, and others, who, in the course of their respective fields, somewhat tend to encroach upon the lawyer and his profession. Throughout the negotiations I tried to approach the subject from the viewpoint of the public interest involved. Neither lawyers nor accountants, nor members of any other profession, have, or are entitled to, a monopoly. The lawyer, when he has sought legislation to define the practice of the law, has been accused of attempting to create a monopoly *in* all transactions where a knowledge of the law is in any way involved. This criticism of the Bar is unwarranted and unfair, especially to those members of the profession who are public-minded and public-spirited.

The approach to the problem must be from the angle of the public interest and the public welfare. Within the last few days the Supreme Court of Missouri, in the case of Liberty Mutual Insurance Company, et al. v. E. W. Jones, General Chairman of the Bar Committee of the State of Missouri, et al., rendered an opinion on appeal from the Circuit Court of Boone County, and approached the problem of the alleged encroachment upon the lawyer by lay adjusters from this angle, saying "in this case we are confronted with questions of business conduct affecting the interests of a large part of the public."

I appreciate, as we all must, that there is an unavoidable overlapping of interests as between the accountant and the lawyer in many instances. As illustrating such overlapping, I might number the following as examples, but in each, the position of the lawyer and the accountant can be carried on without any conflict and in a spirit of co-operation:

1. *In organization, merger and consolidation of corporations** Here the lawyer's duty is that of setting up the corporate records, the corporation minutes, etc., and is clearly distinguishable from the accountant's duty in connection with the capitalization, the setting up of assets and liabilities and the installation of the accounting and bookkeeping systems.

2. *In re-organization of corf orations.* Here too, the lawyer and the accountant are both indispensable; each must be consulted and each must consult with the other in the working out of the numerous problems which of necessity must arise concerning the corporate structure, stock and bond issues, taxes, and the like.

3. *In tax matters,* such as income and inheritance taxes (Federal and State), personal property taxes, franchise taxes, etc. Here, the accountant, by reason of his expert knowledge and his concentrated accounting and business training, is absolutely indispensable.

4. *In matters affected by the Chandler Act, or the Insolvency Acts involving the liquidation or re-organization of business enterfrises.* The co-operation of the accountant and the lawyer in this type of work is indispensable to a fair, just and equitable disposition of the problems presented.

5. *In matters concerning the Securities and Exchange Commission.* There can be no question but that here, also, both the lawyer and the accountant must play very definite roles.

6. *In estate work.* The accountant and the lawyer each has a task to perform, which can be carried out without conflict.

Any one of these enumerations could be made the subject of a very lengthy discussion. Therefore, I shall confine myself to the broad public angle, touching upon the extent to which an accountant may proceed without encroaching upon the lawyer, and how, where common problems arise, they can best be solved in a spirit of co-operation. No two cases can ever be identical. The point of overlapping interests in one case cannot be the guide in another. It seems to me to be of utmost importance that we clearly understand and recognize the prerogatives of each others profession, so that we will know exactly how far each may go without interfering with the other.

There is no room for argument on the question that an accountant should never attempt to prepare contracts, indentures, stock certificates, articles of incorporation, or agreements. Therefore, there should be no difficulty in laying down definite rules concerning encroachment in this field.

I do not believe that the average accountant wants to represent a client in any kind of a formal hearing. However, he should be permitted to represent a client before administrative bodies and agencies, and Governmental Commissions where the issues involved are merely the presentation of facts and figures which, by virtue of his training and experience, he is well qualified to undertake.

Prior to the amendment of the United States Constitution permitting taxes on incomes, the principal source of the Federal Government's income was by way of tariff, and liquor and tobacco excise taxes, while the state and local community was financed principally through real and personal property taxes and some small excise taxes. Since the income tax, however, a varied number of other taxes have been and are being levied locally and by the Federal Government. The computation of the earlier taxes required no technical accounting experience or training. With the advent of additional taxes it became apparent that an accountant, well-grounded in tax administration, was necessary in order to cope with the complex nature of the form of the return and to insure its accuracy. The result has been that many new horizons have been opened to the accountant in the field of tax administration. Accountants unquestionably have been responsible for many of the newly created tax statutes, and the forms of return to be made thereunder, and properly so, for they have the ability, that neither the lawyer nor the layman possesses, to assemble and analyze figures and set up forms with respect to the various items to be reported.

In the tax practice particularly, it is becoming more and more evident that each profession is a complement of the other. No competent member of either of our professions would proceed without the other when the problem presented requires the specialized knowledge and training of the other. It is unfair to the client, and hence a disservice to the public, for a lawyer to proceed with a problem involving the understanding of accounting until it is too late to correct the mistakes that are bound to be made; and on the other hand it is unfair to the accountant's client to proceed with a legal problem until it is too late to correct the errors that he undoubtedly would fall into by such an undertaking.

In the average tax case, whether it concerns income tax, franchise tax, Social Security tax, or some other form of taxation, the accountant must not only perform the actual book work, but must be ready and able to appear before those departments which have charge of the assessment or collection of the tax. When returns are made and filed, they are first reviewed by the accounting division of the department with which they are lodged. At this point the lawyer does not speak the language of the accountant. To me it would seem an extravagance in money and time for the lawyer to appear before the reviewer for a discussion of the contents of the forms filed, for it is more than likely that the two accountants, the one representing the Government and the other, the tax payer, could not only solve the problem, but also shorten the conference by hours. However, once the matter leaves the accounting division for the purpose of collection or prosecution, then the lawyer's services become indispensable, and he and the accountant should co-operate to the end of preparing the case for hearing or trial. From that point on, the lawyer can best defend the tax payer's interests.

In connection with hearings conducted by Government agencies involving tax matters, the accountant has the ability and training which is indispensable to an intelligent discussion of the problems presented, whereas the lawyer, unless he has had special training along these lines, will not be able to represent his client nearly as advantageously. However, when matters of this type reach the point where they require a formal hearing before a Board or Court, where testimony must be presented and evidence taken *in* legal form and manner, then, certainly, the lawyer must enter the picture.

I doubt that any accountant who is sincerely interested in his client's welfare would attempt to handle matters alone and unassisted when they reach this point. Unquestionably he would recommend to his client the retention of a lawyer to collaborate with him.

My experience as a private practitioner, after a quarter of a century at the Bar, has convinced me that in the preparation of tax returns, whether they be for income tax, inheritance tax, estate tax, or any other of the innumerable local and Governmental taxes, neither the accountant nor the lawyer can safely, in justice to his client and the public, single-handedly prepare the return and see it through to final payment. I find that more and more it becomes necessary to rely upon the accountant to assemble the figures, analyze and report upon them, and then, with the facts clearly before me, to apply the particular statute most favorable to the interest of my client.

Tax returns, among other items, require disclosure of income and expense, receipts and disbursements, depreciation, depletion and obsolescense. No lawyer, unless he is qualified by specific training, can properly prepare these returns. He ought not to attempt the undertaking, if the client is to be wisely represented and the return accurately compiled. In addition to these items, valuations of inventory, determination of costs of goods manufactured, purchased or sold, ascertainment of bad debts incurred and written off', and other items of a similar nature cannot be properly reported without the assistance of a trained and experienced accountant. While the compilation of these returns requires the services of an accountant, their preparation frequently involves legal questions which must be settled before the return can be safely filed. When legal questions arise in their preparation, the reputable accountant will insist upon consultation with a lawyer. Under these circumstances, the public is best served, the client is properly represented and the Government is more justly treated.

It is apparent, therefore, from the example just cited, that the line of demarcation, where the accountant should surrender to the lawyer the burden of going forward, is not always clear-cut and definite, and in some cases may be *£.nc* and rather obscure. On the other hand, it is difficult, if not impossible, to give an all-inclusive definition of what constitutes the practice of the law. There are probably as many definitions as there are people who attempt to define it.

The question of how far a lay insurance adjuster or adjuster representing a utility company might go with respect to the adjustment of claims was involved in the Missouri case which I have mentioned. The same question has been raised, although not as clearly, in cases decided in Pennsylvania, New Jersey and Alabama.

Frankly, I opposed, as strenuously as I could, any effort on the part of the organized Bar to institute or assist either side in any of the litigation which has sought to prevent the practice of the law by adjusters, corporate fiduciaries, and others. It is my sincere hope that such litigation will never occur between our professions. I have seen the litigation instituted on behalf of the lawyer resolved against him in practically every case, except only where the violation was so flagrant that the Court was compelled to enjoin it in order to prevent further fraud and injury to the public.

I firmly believe that the accountant has a very definite and indispensable place in the professional and business world. With the intricate methods of present-day business, and the mounting numbers of tax problems that are being created, it is impossible for business to exist without his services. These problems, of course, make it difficult for him to determine the point at which his duties as accountant to his client must cease, and the point at which the lawyer must be consulted.

The accountant and the lawyer should each realize and recognize that in his own field his knowledge is specialized; that in the other's field his knowledge is, at best, scant and superficial and that his experience is very much limited. Ethically, therefore, each must put the duty to be rendered his client, and the public at large, above personal glorification and financial enrichment. The highest service that can be rendered by members of our professions to the public is to respect and abide by the ethics of our professions, and for each to point out to his client the need of the assistance of the other in all cases where accounting and legal problems overlap.

Examining the Missouri case with respect to what does and what does not constitute the practice of the law as respects the lay insurance adjuster, it is apparent that the accountant is supreme in the field of taxation. From the time that he begins preparing the books and records of his client for the purpose of compiling the return, and until the return is completed and filed and informal conferences are had with the taxing authorities, he is, in my opinion, acting within the bounds of the ethics of his profession. When, however, the informal conferences with the taxing agency reach the point where the case must be prepared for trial or some formal record is to be prepared for filing in Court, or with the reviewing administrative tribunal, from that time on the authority to go forward should be turned over to the lawyer, for in him rests the power and duty to carry on the litigation. It would be extremely helpful if the accountant were present at the time of the preparation of the record in such a case.

I have not as yet run across any statement of what constitutes the proper duties of the accountant within his field, but on this subject I believe that I can safely paraphrase the Missouri opinion, which holds that a layman may represent himself in Court, but he cannot in any instance represent another, whether it be for a consideration or gratuitously.

There are approximately 175,000 lawyers in the United States, and I am informed that there are some 18,500 recognized accountants. In addition to this number there are, of course, the accountants who have not had the training or education required or necessary to obtain a certification entitling them to the right to use the designation C. P. A.

To a great extent the law has become highly specialized. Without diligent study and research there are very few lawyers today who can properly engage in the general practice of the law. All of us at sometime must seek the assistance of some person or persons qualified by specialized training in a specific branch. Twenty-five years ago it was a simple matter to form a corporation; the minutes of the incorporators and directors were practically *fro forma* documents; and the question of declaring dividends at the end of the business year was a matter of minor detail, and required no arduous study.

With the complicated system of taxation which has grown up in recent years through the continual changes in the various state and local statutes and the Federal Tax Acts, it becomes increasingly difficult, if not impossible, for the lawyer, without the aid of the accountant, to incorporate a company, particularly if it is contemplated that the business will be engaged in beyond the borders of the state wherein it is incorporated. The problem of no par value stock with its stated values calls for the joint opinion of the lawyer and the accountant. The question of paying franchise taxes for the doing of business in a foreign state would seem to be one of the questions which is not to be answered by the lawyer alone. On the other hand, the question of state unemployment taxes in the various states where the corporation is doing business would seem to be entirely the work of the accountant.

A situation which has recently been brought to my attention involves that of a corporation with a bond issue, having the right, at certain times and under certain conditions, to call the bonds and issue stock in lieu thereof. The issue, which is still outstanding, had a considerable time to run. The question presented was whether or not the corporation must accrue the interest payments on its financial statements, or whether it could carry the accruals as a stock liability, for it had the right to issue the stock in exchange for the bonds and accrued interest. This question, it seems to me, is one in which both the lawyer and the accountant must co-operate in the interest of the client.

Certainly in the original stage of any proceedings with respect to the returns of the company for tax purposes, the accountant should handle the matter exclusively. This applies as well to the proper returns to be made to the Security and Exchange Commission, the Public Utility Commission, the Interstate Commerce Commission and other Government agencies. In any event, to my mind, it is undisputed that the first contact with the public body on behalf of the tax payer should be that of the accountant, cushioned, however, by the opinion of the lawyer on the legal aspects of the problem.

The Missouri Court found and declared the law to be that a lay adjuster might participate in a conference with or before the Workman's Compensation Commission for the purpose of endeavoring to bring about an amicable adjustment of the matters in difference between the insured and the injured employee respecting the payment of compensation, and that such participation by the layman does not constitute the practice of the law.

It seems clear to me, therefore, that the accountant is not encroaching upon the legal profession when he attends conferences called by and with the taxing divisions of the Government and similar administrative bodies.

In conclusion, I want to read an exact copy of a contract prepared by a layman in Negatee, Michigan:

"This instrument, made and entered into on December 27, I933> that being the 27th day of December, between Mitti Mitton, of Negatee, and Lendi Mitton, of the same place, his wife, both of Negatee, Michigan.

"Witness: That in consideration of the reunion and relations and cohabitation together of the parties hereto on this day at my office, that the said Mitti Mitton does hereby promise and agree to and with and between the said Lendi Mitton, that he will not go to more public dances except in company with his wife and other women, and that he will not work at the City of Istaca, that he will not go in company with Betty and Lucy, nor with any other women of good character, and that he will from this date on be for the said Lendi Mitton a true and lawful husband, and that she will be a free woman to go alone to the Brookton on Saturday night, her heirs and assigns, forever."

CHAIRMAN HERBERT: Mr. Kristeller, I want to say that I, personally, enjoyed your address a great deal, and I gather that it was equally enjoyed by your audience here.

I am particularly impressed with the validity of that contract.

You gentlemen may wonder why my introduction of Mr. Kristeller was so brief and so short, in a sense. That is always the difficulty of one who is presiding and introducing, because, if you get on the subject at all, you are almost sure to walk right in on what the speakers have prepared for you, so that is why, even as brief as it was, you found me beginning to infringe, so to speak, on Mr. Kristeller's theme.

The next speaker that you have in this afternoon's session is one of the members of your own profession, and one who is exceptionally well qualified to discuss our topic of this afternoon. Mr. F. P. Byerly, of New York, a graduate of Harvard College and also of the Harvard Graduate School of Business Administration, commenced his active employment as an accountant in 1915, and eleven years later was admitted to membership in the same firm of Price, Waterhouse and Company in New York. I have run across that firm myself in my own legal activities in recent years in connection with the utility practice that I have engaged in, both when I was the Attorney for the Public Utilities Commission in Ohio and also when I was in private practice in the City of Cleveland. I know the firm very well and I know what a high-standing firm it is, and I am very glad to introduce to you at this time one of its members, Mr. F. P. Byerly.

SOME PROBLEMS COMMON TO THE PRACTICE OF LAW AND ACCOUNTING

By F. P. BYERLY, C.P.A.
Member, Price, Waterhouse and Co., New York, N. Y.
Chairman, Committee on Cooperation with the Bar Association of the American Institute of Accountants

In the place I have been assigned on today's program, it is a little difficult to say a great deal that has not been said, or at least touched upon, by one of the previous speakers. At this morning's session, as most of you who are here probably know, it was extremely interesting to get the contrasting points of view of the two speakers. On this afternoon's topic, fortunately for me, but perhaps unfortunately for you as a matter of interest, there is, I think, very little difference in point of view between Mr. Kristeller and myself.

In my work the last year or two on the American Institute of Accountants' Committee on Cooperation with the Bar, a good many of our discussions with the American Bar Association Committee, On Unauthorized Practice of Law, have dealt with these matters of cooperation, or of possible occasional conflict, between the two professions, in tax practice. I am glad to say that Mr. Kristeller covered that ground admirably and much more fully than I could have done. My paper is devoted chiefly to some other aspects of the relations between the two professions.

As has, I think, been made evident by Mr. Kristeller's remarks, there is no real ground for controversy between the professions of law and of accounting. While their main subjects and methods are fundamentally dissimilar, they are in many respects as interdependent as the sciences of mathematics and of physics.

Business law derives from business practice. Accounting derives from bookkeeping. Bookkeeping records business transactions. Business transactions are facts; but in the world of business affairs facts are not entirely objective. The facts as to a transaction, or a financial situation, are often to some extent subjective in that they may be dependent upon purpose and intent. In practice, purpose and intent have to be determined by rules of custom or law. Facts and law are intertwined. Even learned judges have in some cases had to admit that questions of law and of fact were not divisible.

RELATION OF LAW AND ACCOUNTING

Of late years, a good deal has been heard of complaints of bar associations regarding the unauthorized practice of law. Unfortunately, such complaints have not been altogether unfounded. It is reported that many such complaints have been against associations or corporations undertaking to render personal services, some of which have infringed upon the field of practice of law. Lawyers have told me that such unethical concerns have usually been organized by members of the bar itself, who had a flair for business rather than qualifications for attracting clients on a strictly professional basis. Some of them appear to have been able to organize certain phases of legal work on a routine or quantity-production basis in a manner that has been most annoying to more staid members of the legal profession.

Other examples could be mentioned of activities of corporations and laymen which have been proper subjects of attack by vigilant bar associations. To the best of my information, however, any such complaints against recognized members of the profession of public accountancy have been almost negligible.

Not only in business, but in practically all human relations, law has a quality analogous to that which physicists used to attribute to ether—catholic pervasiveness. Inevitably, therefore, lawyers have encountered serious difficulties in attempts to define boundaries between the practice of their profession, on the one hand, and lay activities, on the other. Such difficulties become practical impossibilities in relationships with the sister-profession of accountancy.

The inextricability of law and accounting is particularly apparent in connection with both income tax matters and financial statements. On these two important subjects, the law says that accepted accounting methods, principles and procedures must be the basis. Thus, such accounting automatically becomes the law.

In a paper entitled "Accounting and the Law," presented in December 1937 at a meeting of the American Accounting Association by a prominent lawyer, Mr. A. A. Berle, Jr., the following remarks appear:

> . . . rules of accounting have become, in large measure, rules of law
>
> . . . accounting moved out of the function of a private convenience to business-men, into the legislative arena . . .
>
> . . . As a lawyer, I have to put my accounting books alongside of my Annotated Statutes and my digests of case-law, and so must the judge before whom I argue; . . .

COOPERATION BETWEEN ACCOUNTANTS AND LAWYERS

Let us turn now to typical problems in actual practice of the two professions.

A major function of certified public accountants is reporting upon the financial position and results of operation of business enterprises.

In this work, they do not limit their examination to ledgers or other books of account; they must examine documents to the extent available and necessary for the purpose of the particular examination in hand. Scrutiny of the books and papers must be supplemented by discussions and explanations.

Let me name a few of the legal documents, topics, sub-topics and questions which may have to be considered or reviewed by public accountants in the course of typical audits:

Contracts—o£ endless variety;
Sales—When does title pass? When does profit arise?
Negotiable instruments—loss from laches, liabilities of endorsers, etc.;
Patents—validity, liabilities for infringement, foreign registration, etc.;
Trade-marks—Is their validity impaired by assignment?
Articles of incorporation—State corporation laws are far from uniform;
Dividends—propriety, tax status, etc.;
By-laws—Who are the officers, and are they functioning within their authority?
Income and profits taxes—Federal and state. How much possible liability exists with respect to unsettled years in controversy?
Guarantees, trade and financial—Do these persist in spite of reorganization?
Contingent liabilities—These may be detectible from matters of record or omissions observed in matters of record;
Sinking funds—Differences of opinion in interpretation of documents are common here.

The above are only a few typical topics encountered by auditors. Others which are not uncommon include partnership agreements, trust deeds, franchises, decedent's wills, estate taxes, rules and regulations of the Securities and Exchange Commission under any of the three statutes that it administers, requirements of blue-sky laws and of public service and other commissions of the various states.

The list could be expanded and details added *ad infinitum.*

In recent years, government regulation of business and finance has been so extended that I might well have placed Securities and Exchange Commission and blue-sky law matters in the *tyfical* category, so far as concerns the practice of certified public accountants.

From this rather sketchy outline, it will be apparent why one aspiring to become a certified public accountant must sacrifice a few hours to the study of business law, and the successful candidate must pass an examination in this subject. Such requirements do not mean that the certified public accountant purports to know all the *answers;* but they do reflect recognition of the fact that he cannot carry on the practice of his profession without at least knowing some of the *questions.*

I venture to say that rarely does a certified public accountant carry through a new engagement without encountering and developing questions on which he recommends the client obtain a lawyer's advice or opinion.

Lawyers in turn recognize that the services of certified public accountants are often helpful to them and their clients on many matters beyond the important fields of auditing, cost finding, systematizing, etc.

When drawing an indenture, a lawyer may want the accountant's suggestions as to a workable description of current assets and current liabilities; in preparing a contract involving the sharing of profits, an accountant's aid will be sought in the definition of terms, and he may well be asked to work out an illustrative example to make sure that the words will fit into actual accounts and figures. In the pursuit of damages from infringement of a patent, the lawyer may be almost entirely dependent upon the findings of an accountant. A complete list of such examples would run on almost indefinitely.

THE CURRENT TREND AND THE FUTURE

In the direction of increase in cooperative effort between the two professions, the prevailing trend is clear and appears to be of widening scope and gathering momentum.

During the last decade, attention has been called with increasing frequency to the diversity of accounting practices as reflected in the financial statements of corporations affected with a public interest. A cry has been raised for development of greater uniformity and stability *in* accounting. Such demand has come not only from academic circles but also from investment counselors, financial writers and, last but not least, from the Securities and Exchange Commission. Lawyers who are concerned with corporate practice have recently counseled the accounting profession to work assiduously towards the development of a code of standards, and have called attention to the serious and constructive work which the legal profession has carried on over a number of years in the drafting of uniform state laws on such subjects as negotiable instruments, stock transfers, and many other matters, and in formulating restatements of various fields of law, tantamount to unofiicial codifications.

In June 1936, the American Accounting Association published in the

Accounting Review a "Tentative Statement of Accounting Principles Affecting Corporate Reports," and invited discussion and comment. In 1938, there was published by the American Institute of Accountants, with the generous permission of the Haskins & Sells Foundation, a "Statement of Accounting Principles," completed late in 1937 by Professors Sanders, Hatfield and Moore. The Foundation had recognized the need for impartial study of accounting principles jointly by eminent accountants and lawyers, and invited the three authors to the task as early as 1935.

Among the topics discussed at the annual meeting of the American Institute of Accountants, held in Cincinnati last September, various aspects of accounting principles and procedure were preponderant. These topics were presented in thoughtful and constructive addresses by well-known members of the legal profession as well as by leading accountants.

In recent months, following an extended period of discussion and planning, the American Institute of Accountants has established a Department of Research on Accounting Procedure. It has been announced that at present Professor Hosmer is acting as director and coordinator of research in the absence of Professor Sanders, who is now abroad investigating related accounting problems.

In conclusion, let me warn against expecting too much from these hopeful developments. In accounting, as in law, no codification, however painstaking, will ever eliminate the need for professional skill and judgment attainable only by individual study and experience.

I might add one further thought, which occurred to me as a result @f tke discussion this morning by Mr. Torbet and Professor Winter, on the topic with which I have concluded my remarks. I think it has been said, more than once, no doubt—at least once by a well-known lawyer—that the only place in which the Supreme Court's decisions could be overruled is in the law journals of this country. The contributors to these journals are sometimes students, sometimes members of the faculty, and sometimes, practicing lawyers; and it is well-known that some of these law journals present articles that are very thought-provoking. They have the academic freedom from bias, and impartially dissect and criticise, without any particular sense of pity to the court whose decision they may be reviewing, the line of reasoning in comparison with previous cases and dicta. Undoubtedly, members of the Bench as well as members of the Bar read the articles in these law journals that relate to their particular specialized fields, and no doubt they get many sound ideas from these criticisms.

It seems to me possible and perhaps probable that this research activity that goes on in a university such as this, and that is being undertaken in a joint way, under the wing of teachers of accounting and practitioners, by the American Institute of Accountants, while it can never produce a rigid code, never reduce all the questions of accounting to a simple rule book, will, in due course, produce a certain amount of literature, comment, discussion and exchange of ideas and criticism of past practices, many of which, I fully agree with Professor Winter, deserve a good deal of adverse criticism. So, in the long run, this research activity may have a salutory effect both upon accounting law and upon the practice of accounting.

CHAIRMAN HERBERT: Mr. Byerly, I can only say that, after listening to you in that talk, I am rather glad for the sake of my brother lawyers that you have not seen fit to qualify yourself as a lawyer as well, so that you would engage in the active practice of law. That remark about everyone being supposed to know the law, and that you cannot understand why, with that assumption, the lawyers try to prevent the layman from practicing a little bit of wliat lie is presumed to know, is really a problem that I do not want to have to answer. (Laughter.)

It has been suggested that we really turn this into a sort of open forum, and both Mr. Kristeller and Mr. Byerly have very kindly agreed to attempt to answer any questions that may be put to them. In the absence of any such question—

QUESTION: Maybe Mr. Kristeller can interpret that contract for us. (Laughter.)

CHAIRMAN HERBERT: I think the contract might be termed self-executing. (Laughter.)

If there is nothing further, then I will declare this afternoon session adjourned.

FOURTH SESSION

FRIDAY, MAY 19, 1939—7:00 P.M.

The Faculty Club

Chairman:

W. C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University*

Address: "The Need for Good Accounting in the Affairs of Government"

THE HONORABLE JOHN W. BRICKER, *Governor of Ohio*

INTRODUCTORY REMARKS

By WALTER C. WEIDLER, *Dean*
College of Commerce md Administration, The Ohio State University

This is a very happy occasion for the Department of Accounting and the College of Commerce of the University. It is very gratifying to see the response of accountants in Ohio and surrounding areas to the program which the Department has planned. It is always very heartening to us at the University to see so many of our friends come back—as I look around this room I see a good many faces that were here at the Accounting Institute last year. It is a very great pleasure to welcome you here, and may I express the hope that you will be back with us in another year.

Now, there are a number of gentlemen here this evening whom I would like the privilege of introducing. The farthest one at the table is Mr. Earl G. Graham, a member of the Board of Directors of the Ohio Society of Certified Public Accountants.

At the end of the table is Mr. Harry Cuthbertson, President of the Ohio Board of Accountants.

On Mr. Cuthbertson's right is Mr. Albert W. Torbet, partner of Frazer and Torbet, of Chicago.

On his right is Mr. Homer L. Dalton, President of the Ohio Society of Certified Public Accountants.

The next gentleman is Professor S. G. Winter, Professor of Accounting, the University of Iowa, and President of the American Accounting Association.

And on my left, Mr. George D. Bailey, partner of Ernst and Ernst, Detroit.

And on my right, three removed, the Honorable Thomas J. Herbert, the Attorney General of Ohio.

The next gentleman I would like to present is Mr. William F. Marsh, partner of Lybrand, Ross Brothers and Montgomery, Pittsburgh, Pennsylvania.

Now, no meeting of this kind would be complete, I think, without presenting our good Professor Taylor, Chairman of our Department of Accounting at the University, who, as you know, also happens to hold an important post in the State government at this time. Professor Taylor.

PROFESSOR JACOB B. TAYLOR: Last year when we had this meeting in this room, you will remember that just about the time Dean Weidler introduced me it began thundering and lightning. Dr. McClure said, "God is with you, Jake; every time you speak He applauds." I am going to quit before the thunder and lightning commence tonight.

We are deeply appreciative of your interest in coming back to this second Accounting Institute. Our audience is not quite as large as it was last year, but when you consider that we have Conferences all around us, some of them meeting the same day, I think we have done pretty well to have the fine attendance we have here tonight.

One thing we are going to do is to demonstrate to the people of this country that there are great and good things in accounting that can come out of Ohio. With this live, energetic State Society of ours, the fine cooperation that it gives those of us *in* The Ohio State University, these Institutes on Accounting can point the attention of the people of this country to the things which are being done *in* an accounting way here. Our aim is to make these Accounting Institutes so significant and so important that they will not only serve the profession in the State, but stand as periodic proof to the country at large of Ohio's rich contributions to the accounting profession. It is with that firm resolve that we go into this second meeting, and I think, in the days which lie ahead of us, these meetings will be one of the fine traditions of the accounting profession in the country.

Thank you again for coming back, and I trust that the rest of your stay will be as pleasant for you as it has been for us in having you here.

CHAIRMAN WEIDLER: The gentleman whom I am about to introduce at this meeting is one who inspires in all of us at Ohio State very special pride, because he is the first alumnus of this University who has risen to the high office of Governor of the State of Ohio. So this is a most significant occasion for me—the opportunity to present the Governor of Ohio, who is also a graduate of this University. This University takes a very special pride *in* the Governor, not only because he is a graduate of this University, but because of his many sterling qualities and because of his very fine capacity for friendship and because of his very splendid personality.

Ladies and gentlemen, Governor John W. Bricker.

THE NEED FOR GOOD ACCOUNTING IN THE AFFAIRS OF GOVERNMENT

By THE HONORABLE JOHN W. BRICKER
Governor of Ohio

I am gratified that even at a late hour I am able to be with you for a while this evening.

Columbus, of course, is benefited, and benefited greatly, by those who come into our midst from out of the city, just as Columbus is benefited greatly by those who are studying in the University here, just as Columbus and Columbus business is benefited greatly by the research that is done and by the teaching that is done by those in the Department of the University concerned with your professional work particularly.

I suppose that the law and the profession of accounting cross more frequently today than ever before, and will continue to multiply in those mutual interests. I remember it was about 15 years ago when a member of Congress dropped into my office and seemed almost prophetically to look forward to this day of complicated government financing, and he said, "That man who will render public service in the days that are ahead, the next quarter of a century, is the one who is able to understand government financing, to read a set of books, who understands money and its value, its relationship to property and its relationship to labor."

I think the proof of his statement is all about us everywhere, in local government, in state government, and particularly in Federal government.

When I entered this University *my* friends told me to take political science, lots of history. Not much attention was paid to accounting, not much attention was paid to commerce. In fact, the College of Commerce and Administration was just organized about the time that I was in school here.

But today when one comes to my ofiSce and asks me what ought to be a prerequisite to the study of law, I am bound to tell him that he ought to take as much as he can of accounting; he ought to be able to read and interpret a set of books; he ought to understand financing and get just as much of economics as he possibly can into his four years of pre-law work.

The whole emphasis in my profession has been changed because of the complexities in corporate financing, and particularly in government financing, which we have been experiencing in the last ten or fifteen years.

I suppose that the State Government could not operate unless it had the aid of the profession which is here represented.

I want to say to you very frankly that, when I came to deciding and choosing an individual to head that department of government that handles more money than possibly any other department, with the exception of the Highway Department, I thought the one most competent to handle it was one of your profession. Frankly, I would rather have one who understands figures and is able to read them at the head of that department of government. I know, too, that I can trust his judgment and ability further than any other. That is the reason I called on Jake Taylor. He was not an applicant for a political job, and it took a great deal of pressure to get him to accept it, I want to say to you frankly. He has been doing a remarkable job there, because he possesses the qualities of disciplined accuracy, knowledge of business process, and the ability to penetrate beneath the surface of things which are so characteristic of the members of this profession of yours, a profession which is so essential in government activities.

I have ofttimes wondered what has been the most stabilizing influence in the past few years in our government activities, and what has made possible the tremendous expansion of government that we have experienced. After all, it has been because those who have been professionally trained, those who have had the advantages of educational opportunities such as this group essentially represents, have been willing to give up their time to the business of government. You would only have to sit in my office a little while until you would realize that many who apply are not competent to do the things that they hope to be trusted with. When one has a real job to do, he has to go out and find the men to do it. Day by day, I am more and more impressed with the fact that government needs and will require more professional services in the years that are ahead than it has in the years that have just recently passed, if we are to be able to withstand the storm and the pressure, if we are to be able to solve the economic problems that confront us, if we are to be able to adapt and adjust this rather fixed system of government under which we live to the complex social problems, to the industrial needs of this age.

So I want to express to you the thanks of those who are in official capacity at this time for the service that accountants, individually and collectively, have rendered to government. The citizens of this country owe much to the profession that is here represented for the great, constructive service you have rendered, and the great remedial work your profession has done for government in recent years. The lawyer could not solve many of the income tax cases, the prosecutor could not convict those who were guilty, the Congress of the United States could not conduct the investigations which have meant so much in straightening out the tangles which have existed in our whole governmental structure; little of this could have been done had it not been for those who represent the profession of accounting. The accountants have worked out the cases, they have laid before the lawyer a solution of his problem, they have even prepared the questions that many of the investigators have propounded to witnesses, as you well know.

So, government activity has been dependent to a great extent on those in the accounting profession, and will continue to be. The citizens of the country are thankful for the fine work you have done in cleaning up government. I would rather have a dozen lawyers after me than someone with a pencil who can actually figure. But, put the both of them together and it makes a very strong combination. I see Tommy Herbert laughing over here, but he knows how dependent the Attorney General's office is upon professional services in the accounting field. I experienced that myself for about four years there.

I do want to express the thanks of the State Government for the fine help which the accountants of the State have given. Corporate structures could not go on, business could not be conducted without this kind of professional service. And so I am appreciative, Dean Weidler, and Mr. Taylor, for the invitation which you gave me to come up here and join with you and give you this word of greeting.

DEAN WEIDLER: Thank you, Governor Bricker, for those very stimulating words. This is just one more demonstration, I think, of your fine spirit, and I want you to know how deeply we appreciate your coming here in the midst of a very busy day and spending a little time with us. Thank you again.

FIFTH SESSION

SATURDAY, MAY 20, 1939—10:00 A.M.

Chairman:

JOHN T. MADDEN, *C.P.A., Dean, School of Commerce, Accounts, and Finance, New York University, New York, N. Y.*

Topic: Auditing Procedure—A Development to Meet Changing Conditions

Papers:

GEORGE D. BAILEY, *C.P.A., Partner, Ernst and Ernst, Detroit, Michigan*

WILLIAM F. MARSH, *C.P.A., Partner, Lybrand, Ross Brothers, and Montgomery, Pittsburgh, Pennsylvania*

INTRODUCTORY REMARKS

By JOHN T. MADDEN, *C.P.A.*
Dean, School of Commerce, Accounts, and Finance, Nezv York University
(With Introduction by WALTER C, WEIDLER, *Dean, College of Commerce and, Administration, The Ohio State University)*

DEAN WALTER C. WEIDLER: Gentlemen, it is my privilege this morning to present the Chairman of the morning's session. Now, this Chairman is a most versatile gentleman. He is the Dean of the New York University School of Commerce, Accounts and Finance, which is probably the largest College of Commerce in America.

In addition to being a very wise and able administrator, he is, as you know, a distinguished member of the Accounting Fraternity. How he finds the time to administer the affairs of a College as large as his and at the same time to maintain an active position among the Accounting Fraternity, I do not know. He must be a gentleman of prodigious energy.

Not only has he these very important professional attainments, but he is also a most unusual personality, and I suspect some of you know him as a great story-teller. I have had the pleasure of sitting in on a few sessions in which he contributed much to the program. His is a most genial personality. But you know him rather well. I think I need not say more.

DEAN JOHN T. MADDEN, *Chairman of the Fifth Session:* It is always a good thing, you know, to have a little taffy in one's lifetime, rather than a lot of "epitaphy" after he passes from the scene of action. That accounts for the very flattering introduction today.

It is a great pleasure for me to be again on this campus. I was royally entertained here some years ago and I welcomed the opportunity to come back.

I first came in contact with this august profession of accounting many years ago, more years ago than I like to admit today. I was visiting in London with a friend at a business office, and about ten o'clock in the morning the auditor of the company came in. I have never seen an auditor come into a client's office attired as he was. I understand he wore the customary garb, which is a Prince Albert coat and a silk topper. I am wondering how many of us come to our client's offices dressed that way. That was my first contact with this creature known as the auditor.

About 1900, I think it was, I knew something more about him because that was the era, you know, of trustification in this country, when the United States Steel Corporation was organized, and when this item, "good will," came to be very important in our balance sheets, along with "watered stock" and things of that sort. Then we had a good deal to do with business from 1900 on, and I did come in contact with auditors more at that time. They were looking for fraud in accounts and trying to catch the thieves and rascals who were embezzling small sums. I recall seeing an audit program in that day in which, instead of doing any checking or posting from the ledger, the procedure was to build up on sheets of analysis paper the footings of the books of original entry and so *in* that way to arrive, on sheets of analysis paper, at the trial balance as shown by the ledger. Thus, the postings were checked in that way without making any check marks on the ledger. I thought that was a very good idea, because the bookkeeper had taken a lot of trouble in writing up his books. They were like copper plate engraving, and he did not have any smudges of auditor's check marks in the ledger account.

Then in 1909, you know, we began to have the excise tax, and we heard more about auditors. We heard at that time we were going to determine profits by the difference between receipts and disbursements, according to the law, at least. In fact, we had a Supreme Court Decision to the effect that, if a company took in more receipts than disbursements, that was the amount of the profit. The auditors had educated the public at that time that profits were determined by the excess of revenues over expenses. At that time, accountants began to get prosperous.

The Income Tax Law was passed in 1913, and it was about that time we heard something about this so-called balance sheet audit. In 1914, of course, the World War came in and accountants began to be more prosperous, too, and then it was that we had these price gyrations—changes in the price level—which caused all of us a lot of grief after that, and perhaps that trouble has not entirely disappeared yet.

Then *in* 1917, you know the Federal Reserve put out that statement as to verification of financial statements.

And then, 1919 and 1920, when the market crashed and commodity prices fell, we began to hear a great deal about the cost or market rule for taking inventories.

In 1923 to 1928, we had a fairly high plateau of commodity prices, and people thought that we were more permanently on a higher plateau of prices, and then it was that we began to have difficulty with revaluation of assets, to bring them in line with present-day price levels.

I recall going down to Bedford Springs in 1925 to a meeting of the Pennsylvania State Electric Association and telling them there that I thought the future of auditing or accounting was greater than ever before; that I did not believe we had enough C. P. A.'s in the United States to do all the auditing work that ought to be done, and I foresaw the day, or thought I foresaw the day, when we might have an officer of the corporation known as an auditor who would be elected by the stockholders, who would work with management, but who would report independently of management on the operations of the business.

Well, then we had the reorganization era, from 1929 on, which caused all auditors a great deal of difficulty. We began to hear more about this peculiar thing known as capital surplus, and I recall that the late John R, Wildman and others were trying to establish accounting procedure so as to arrive at a classification of accountancy services.

And in the meantime, of course, our various public utility commissions were working on their classifications of accounts; many industrial associations were working on classifications of accounts for private industries. The Securities Acts in '33 and '34 came in, leading up to the Public Utility Holding Act, and then it was that some bright chap conceived the idea that public utilities should have their property accounts stated on the basis of original cost. In other words, we could go clear back and find out what the original cost of a property was when first devoted to public use, no matter how many changes of ownership had intervened in the meantime, I was wondering what that would lead to if a public utility could go back very far. You know, the Island of Manhattan, where I do most of my work, was once purchased from the Indians for 24 dollars in cash and two bottles of rum, and I am just wondering how you would work out the original cost of that property when first devoted to public use!

Well, that went on, of course, and we began to realize that our balance sheets were not worth very much anyway because of all these changes in price levels that we were adding into the property accounts. We became a little more "economics-conscious," I suppose—tried to pay a little more attention to the income account—and so we are here today to discuss the subject of auditing procedure, a development to meet changing conditions.

Well, as I look at it, the accountants are in for a more prosperous year than ever before. I recall some years ago talking to an industrialist and he said to me, "We haven't any use for accountants in this shop of ours. Of course," he said, "we have about 20 companies tied up in our organization. Once in a while I do have an auditor's statement in the drawer of my desk in case a curious stockholder happens to wander in here and I can show him the Auditor's certificate, but otherwise we do not have any of the accounts of the company audited."

So I think that this legislation may help to strengthen your hands, particularly in dealing with some clients who are very lacking in certain ethical concepts. Of course, you have a great deal of difficulty. Accounting is a very limited mechanism. But you are dealing with economic factors, with law, and with statistics.

In your deductions statistically, I know you will be more accurate than Pat was. Pat was an Irishman who lived in New York, and in due course of time he went over to the old country and brought over his sweetheart Mary, and they were married. At the end of the first year of married life, there was a baby *in* Patrick's family. At the end of the second year, there was another baby in Patrick's family. At the end of the third year, Patrick and Mary had made another donation to the matrimonial fruit-basket, and likewise at the end of the fourth. Then four years rolled by and there were no more additions to Patrick's family, and one of the neighbors, more curious than the others, finally said to him, "Pat, how is it, here every year for four succeeding years you had a baby in your family and now four years have gone by and there are no more babies in your family?"

"Oh," replied Pat, "I read the papers and I see by the statistics that every fifth child born in the City of New York is a Jew, and I stopped with the fourth."

In this corner, we have Mr. William F. Marsh, C.P.A., partner of Lybrand, Ross Brothers, and Montgomery, while over on this side we have the representative from the good old State of Michigan in the person of Mr. George D. Bailey, C.P.A., partner of Ernst and Ernst. I see that he is scheduled to appear first, and the only way to have a little match is to start it right away. So I, therefore, take pleasure in presenting to you Mr. George D. Bailey, C.P.A., of the firm of Ernst and Ernst, Detroit, Michigan, who will address you.

AUDITING PROCEDURE—A DEVELOPMENT TO MEET CHANGING CONDITIONS

By GEORGE D. BAILEY, C.P.A.
Partner^ Ernst and Ernst, Detroit > Michigan

It is a great pleasure for me to be here today. I have watched, with a great deal of interest, these developments of accounting forums and other meetings whereby the Universities have provided a chance and a means of discussion on various fields of business activity. The public interest in those meetings, it seems to me, has been growing steadily. I think they are serving a useful purpose, and I was very glad to come here today and contribute what I could to this meeting.

There is another reason for it, of course, because my first practice of public accountancy was in the State of Ohio, and my first accounting certificate was obtained by examination in this city. It is strange how I could have forgotten that. I just said I never was in this city except to change trains, but it suddenly occurs to me that I spent three very busy days here one time. A good deal of water has gone over the dam since 1916 when I got that certificate.

Modern American business as we know it now can be said to have begun some fifty years ago, and since that time has been constantly increasing in size, in complexity and in the reliance of each of the various elements of that business structure upon other elements. The participation of the auditor in that business structure has been constantly increasing during the entire period. The public has placed an increasing reliance upon the auditor, and has come to use the accountant more and more in meeting the business problems. The certification of certified public accountants on financial statements of business concerns has come to be relied upon more and more. During that period there has been some criticism of the accountant, it is true, but the criticisms have been isolated and have had little, if any, deterring effect upon the public acceptance of the certified public accountant.

This increasing contact of the certified public accountant with the public as a whole has made information concerning audits and auditors a matter of much greater public interest than in the past. This is particularly true of news which has reflected adversely upon the work of the auditor, and unfortunately there have recently been a number of instances of that kind. The Securities Exchange Commission, in the course of its inquiries into specific audited statements, apparently finds it necessary, for technical reasons, to couch its complaints with respect to financial statements in language which charges them with being false and misleading, although the criticism of the statements may be limited to a highly technical and debatable accounting point. Nevertheless, the series of news releases which has charged statements with being false and misleading has been bound to have a somewhat serious effect upon the public's reliance upon auditors. In addition, there have been two highly spectacular frauds involving companies whose statements have been approved by independent public auditors, the more recent of which involved so much money, and was so easy to visualize, and had so many elements of news value that almost everyone was familiar with the fact that an audit had not disclosed a substantial fraud. All of these added together have had a tendency to make the public wonder whether auditing was proving inadequate to the stresses and strains of present-day business requirements, and it was entirely proper that there should be inquiries into present-day auditing.

Two inquiries started somewhat simultaneously. The professional societies met the challenge by immediately appointing committees to reexamine what had been considered to be standard practice, and see whether extensions of audit procedure were necessary, and whether there were other phases of auditing that needed overhauling. For the public, the S.E.C., in the course of its hearings on the McKesson & Robbins case, decided to inquire into auditing procedures and practices as they actually existed. To that end, the Commission called as witnesses twelve men whom it felt to be not only expert in auditing but representative of various different approaches to auditing practice, including large firms and small firms, practitioners from New York and from outside New York, and one or two men with a background of teaching of accounting. The inquiry appears to have been much more extensive than was required by the immediate case and was not directed solely to the problems of the McKesson 8c Robbins case. The work of the special committee of the American Institute of Accountants, which worked with a special committee of the New York State Society of Certified Public Accountants, has resulted in a report on extensions of auditing practice which will be discussed in detail by Mr. Marsh this morning.

The testimony of the twelve witnesses on accounting procedure is so important as a disclosure of present-day auditing practices that I will devote my time this morning to that inquiry. Two of the specific points, such as the inquiry into inventories and the advisability of confirming accounts receivable, are so closely related to the final report of the committee of the

American Institute of Accountants that those two phases will also be discussed by Mr. Marsh.

It is undoubtedly too early to appraise fully these hearings. There has been no indication from the S.E.C. as to the conclusions it will draw from the testimony or as to what changes it may think to be necessary in its own rules. However, it is not too early to understand that these hearings and the testimony have great importance to practicing professional accountants throughout the United States. You have, most of you, read what the April issue of the *Journal of Accountancy* says on this point:

> The expert testimony fills more than 1500 pages of stenographic transcript. It will be truly a mine of information for students and practitioners. In our opinion the value of this testimony both to the profession and to the public is incalculable. In the first place it shows generally a common acceptance of minimum standards of auditing procedure. On the other hand, there are enough differences of opinion among the witnesses to show a wholesome and vigorous independence of thought. . . . Every word of every witness is well worth careful reading.

In my opinion, no greater mistake could be made than to assume that this testimony is important only where reports are filed with the S.E.C. The principles enunciated and the minimum procedures indicated are stated to be for reports of accountants who certify financial statements for the Commission, for stockholders, or for credit purposes. The philosophy of audit procedure as disclosed by that testimony (except where changed by future pronouncements) will undoubtedly represent standard practice and normal procedures upon which the public will have a right to rely. The Committee of the American Institute is continuing its activities as to whether it is necessary to recommend any other changes in auditing procedure beyond the major ones covered in the recent report. The S.E.C.'s final report will undoubtedly have some specific recommendations. Nevertheless, while it is too early to appreciate the testimony in detail, and certainly any conclusions which" I may appear to draw from the testimony will have to be challenged as one man's early thinking on the subject, it is not too early for those interested in accounting and auditing to know about that testimony, the fields which it covered, and the opinions given.

In the first place, the witnesses were selected with a very evident desire to get various shades of accounting thought. No fault can be found with the witnesses, although other equally satisfactory groups of a dozen could easily have been selected. It is significant that the investigation was not a "witch hunt" nor did it seek to prove a predetermined answer. The examination was not conducted by the legal staff but by the chief accountant of the Commission—an accountant trying to find out from accountants what was going on. The questions were given to the witnesses several days in advance.

There were 129 formal questions. Generally, all were asked of each witness. The testimony follows a definite pattern, and that of one witness is definitely comparative to that of another. In addition to the 129 prepared questions, there were others scattered through each inquiry which were believed to be necessary to develop fully an answer which might not have gone to its logical conclusion. Each witness was given a full day. The testimony started at 10:00 o'clock and went to 12:30 or 12:45, resumed at 2:00 and usually went until after 3:00 o'clock, sometimes until nearly 4:00. The questions themselves are very interesting. It is unnecessary to read them in full as many of them will appear in the *Journal of Accountancy*, and the testimony itself is to be printed and made available for wide distribution. However, the questions can be divided into a number of different classifications, such as the kinds of audits that are customarily made; the inquiry into the bulletin of the American Institute on *Examination of Financial Statements,* and the extent of its applicability to auditing practice; the inquiry into the internal organization of an auditor's office and the extent of supervision given by the principals of the organization; the inquiry into the meaning of internal check and control and its effect upon the audit program; the inquiry into various phases of the audit program as discussed in the bulletin *Examination of Financial Statements* on cash, receivables, inventories, miscellaneous balance sheet items, and profit and loss accounts; the inquiry into the complete propriety of the standard auditor's certificate, and the matter of qualifications or explanations and the necessity for explaining any departures from normal procedures; and the inquiry into a number of related points, such as the propriety of the client determining the scope of the examination, rotation of auditors, appearance at directors' meetings, possible changes in the methods of selecting auditors, and of receiving auditors' reports.

It seems to me the testimony did indicate that there has been sufficient experience with test confirmation of accounts receivable and test inspection of inventory quantities or inventory procedures so that such confirmations could safely be emphasized as normal audit procedure, and the report of the Institute committee does define such procedures as normal. Otherwise, it seems to me that the testimony did not disclose any glaring weaknesses in the auditing procedures, practices, or structure which needed immediate change. Undoubtedly, the testimony will serve to sharpen our concepts of standard auditing procedures, and give to the best practice such authoritative support that it can not be disregarded. The testimony showed no insistent demand from the auditors that their position be made more independent, and that the domination of the auditors by management had been the isolated case rather than the usual. As a general rule, there was substantial unanimity among the witnesses as to good practice, but there was suiBcient diilerence among them to show complete independence of thought, and I think no one can read the testimony without feeling that there was a full and frank disclosure of the thinking of the individual witnesses. As an illustration of what I mean as to sharpening of practice, the witnesses all testified with respect to the kind of a review of the field work and working papers that should be made. Shortly thereafter, in connection with the Interstate Hosiery case, and undoubtedly growing out of that case only, the Securities and Exchange Commission paused in its opinion to discuss review of audit reports. The paragraph appears to be sufficiently illuminating to justify reading it to you, because, while *it* sets forth nothing new, it does emphasize good practice and goes far towards establishing it as standard.

EXCERPT FROM OPINION OF SJ6.C. ON INTERSTATE HOSIERY MILLS, INC.

We think it is self-evident that the review upon which an accounting firm assumes responsibility for work done by subordinates must be more than a series of perfunctory questions as to the performance of particular items in an audit program. Nor should explanations of unusual items be accepted by a reviewer without support in detail from the working papers. As a matter of principle, a review should, it seems to me, be designed with two objectives in mind: first, to insure the integration of the original work papers with the financial statements 5 second, a searching analysis of the ultimate facts developed in the course of the actual audit. An adequate review with the first purpose in mind should serve not only to disclose intentional or accidental misstatements but should also serve as a method of internal check and control on the work of the firm's subordinates. This branch of the review, it seems to us, need not necessarily be carried out by a partner but should at least be done by one well versed in the procedures adopted by the firm and in the general principles and terminology of auditing and accounting. If not a partner of the firm, such review should, in our opinion, be made by persons who are independent of those actually performing or supervising the audit work as well as of those who prepared the draft of the financial statements. The second branch of the review is designed to enable the accounting firm to interpret intelligently the figures it has obtained and to which it is to certify. This part of the review should, it seems to us, be made by a person, preferably a partner, qualified by his knowledge of sound accounting principles and his familiarity with the accounting phases of the industry and the more important problems of the particular company. In this manner the facts ascertained by competent employees can be subjected to the independent and broader judgment of a more experienced person who can by searching inquiry of the supervisor or senior and by examination of significant items in the work papers and schedules reach an informed judgment both as to the adequacy of the audit work done and as to the integrity and clarity of the financial statements themselves.

Obviously, I can not attempt to cover a large number of the questions that were asked. I have, however, selected some which I thought might be particularly interesting to this meeting, and have given a summary of what I believe to be the consensus of the testimony on that point. These summaries are entirely personal, and I need not point out to you the danger of accepting any one man's summarization of the opinions of twelve different people.

I am sure you are all familiar with the booklet, *Examination of Financial Statements,* as revised by the committee of the American Institute in 1936. The booklet was used as a background of the inquiry. The "pamphlet deals with the accountants* examination of the balance sheet of a business enterprise at a specified date and of the profit and loss and surplus accounts for the period under review, and also with his review of the accounting procedure for the purpose of ascertaining the accounting principles followed and the adequacy of the system of internal check and control." It was designed not only for use by accountants but also for others, and it was hoped that the public interested in the work of accountants would thoroughly familiarize itself with the pamphlet. The last hope does not seem to have been fulfilled, and I even suspect that the pamphlet may not have received as much attention from practicing accountants as it should, for there is some ground for a belief that some accountants felt that the pamphlet applied to larger companies listed on the various stock exchanges and did not apply to small companies. The pamphlet is being revised, and the emphasis *given* the old one by the inquiry will undoubtedly give the new greater standing and cause it to be quite widely read.

With that background we can proceed with individual questions:

Question 14—What was the purpose of preparing and publishing such a bulletin?

Question 25—Among the types of services rendered by your firm, how would you classify the examination contemplated by this bulletin?

Question 16—In such examinations are the principles of the bulletin of general application to all types and sizes of companies?

Question 17—In your own practice, do you follow this bulletin as a general guide in such examinations?

Question 18—Do you require all of your staff to be familiar with it?

Summary

The purpose in preparing and publishing the bulletin was to furnish for the profession and the public an up-to-date outline of accepted procedures followed by independent auditors in certifying to statements and in preparing reports. It not only outlines the functions, but limitations of the work.

In general, the bulletin procedure is followed in practice and the staff men are familiar with it, although most firms have their own adaptation and elaboration of the bulletin, which they follow, rather than the bulletin, itself.

This gives the bulletin further authoritative standing.

Question ig—Speaking generally, do you regard the steps prescribed by the bulletin as a minimum or maximum for this type of examination?

Summary

Most of the answers indicate that the bulletin may be considered to set forth minimum procedures "in its philosophy." However, it is pointed out that in some cases some of its procedures may be dropped out and others added. No one said its procedures were maximum though some did not give any definite answers. It is a fair conclusion that the consensus is "minimum in its philosophy."

Burden is on the accountant if procedures are omitted.

Question 24—When accepting an engagement, by what representative of your firm is the scope of such an audit determined? Is the scope of the audit re-examined annually in the case of a continuing engagement?

Question 25—From your experience, who would you say decides such questions (as to the scope) on the part of the client?

Question 52—If weaknesses are found in the accounting and control procedures, do these require additional steps in the audit program? Can you give some illustrations of such situations? Would the additional work be discussed with the company? If the company objects to additional work deemed necessary, what is your practice?

Summary

Witnesses were generally agreed that the client could not dictate the scope of the work which the auditor should follow in his examination. The possible exceptions to this were the work on physical quantities of the inventory and the complete confirmation of accounts receivable, but even in those cases the auditor did not feel justified in accepting the restrictions unless he could be reasonably satisfied otherwise. Even on accounts receivable most firms indicated a practice of some confirmation regardless of the wishes of the client. Generally the client's wishes with respect to the scope would be considered by the auditor only with respect to extension of the procedure beyond that necessary to satisfy the auditor and as to directions for investigation of special phases. There seems to be no fixed practice as to which of the officers of the client might discuss the scope.

As to the auditing firm, the scope in the final analysis is passed upon and approved by a partner or a manager, although in the first instance it might have been developed by a supervisor.

Question 26—Looking to the future, do you think there should be any change in the method of selecting auditors and fixing the scope of the audit to be made? Why?

Summary

In general, the testimony is to the effect that the auditors should be employed by the Board of Directors and should report to the Board either as a whole or through committees. There is little advocacy of stockholders approval (Stempf) but on the whole there is a denial of any important advantages of that procedure.

Question 2Q—Are such (staff) assignments permanent for successive audits?

What reasons underlie the policy you follow in this connection? Do you recognize any disadvantage in your policy?

Summary

The opinion of the witnesses on the rotation of auditors is divided. Seven of the twelve thought rotation desirable in order to obtain a new viewpoint of the procedure and problems. However, they also expressed the advantages to be gained by having an experienced man on a complicated job permanently.

The other five witnesses expressed the opinion that the men might be assigned permanently because of the greater efficiency with which they could proceed as a result of the accumulated knowledge of previous audits by them.

In all cases emphasis was laid on a review of the propriety of the audit procedure of the preceding year.

Question 50—How do you recruit juniors for your permanent staff? Temporary staff?

Question 31—What training or experience do you, as a general matter, require or look for in men applying for junior accounting positions?

Summary

In general, the permanent staff is recruited from the temporary.

All require some accounting background, and most specify college training with accounting majors. The requirements for the temporary staff, as a rule, are not as rigid as for those considered permanent.

Personal characteristics generally required are: Judgment, personality, responsibility, clerical aptitude, etc.

Question 4$—What do you understand the term "internal check and control" to mean? Will you indicate briefly some of the common basic features of a system of internal check and control? What is its purpose? Can it always be used? How is it to be distinguished from a system of internal audit, if at all?

Summary

A system of internal check and control means essentially that the organization and routine are so divided that there is such a division of duties that no one person can profit by falsification of records and that any considerable error or fraud perpetrated by one person will be discovered by another. In order to be effective, the personnel and records must be extensive enough to enable a system of internal check and control to function.

A system of internal check and control is primarily concerned with the original handling, while a system of internal audit necessitates a subsequent review or a check of the recorded transactions.

Question 46—The bulletin states (p. 7) that the nature and extent of the examination depends on the purpose of the examination, the amount of detail included in the statements to be covered by the report, the type of business the accounts of which are to be examined, and the system of internal check and control. Will you explain briefly the effect of each of these factors on the scope of the examination?

Summary

Witnesses agree that the purpose for which an audit is being made dictates the scope of examination. Audits made for the purpose of prospective financing or credit purposes require specific information on operations for prior years and on prospective earning power. Receivers are chiefly interested in assets and liabilities. Clients' wishes regarding special phases of the organization would also require consideration in deciding the scope of the audit, but not to permit less than an acceptable minimum.

The amount of detail given in the statements, especially the operating section, information required by the client and the number of transactions, have a bearing on the amount of checking to be done.

Various types of businesses, such as banks, brokerage, public utilities and manufacturing and the type of accounts, each require special treatment in deciding the scope of examination.

The completeness of internal control should be such as to satisfy the auditor of the authenticity of the records. The degree of completeness should determine the amount of work to be done by the auditor.

Question 47—At pages 7 and 10 it is indicated that Section II is for small or moderate size businesses and that for larger ones the modifications of Section III should be made. Can you explain the criteria used for this distinction—that is, is it aggregate assets? Or assets of each company or branch? In general, is size measured by assets, capital employed, sales, or volume of transactions?

Summary

The witnesses generally agreed that extent of the system of internal control depended on the number of transactions rather than dollar volume, etc. There must be enough transactions to require a force large enough to make internal control possible. Before the scope of work indicated by Section II could be modified, the internal control had to be effective.

The problem is to determine the authenticity of the records and the work necessary to determine that underlying authenticity (as distinguished from accuracy) can be reduced only upon evidence of increasing effectiveness of the internal controls.

Question $4—Should an examination in accordance with this pamphlet disclose fraud? In this connection will you outline briefly your understanding of the meaning of page 10, paragraph 2, second sentence, which reads: "the procedure will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions, or by manipulation of the accounts?" Do you think the auditor should satisfy himself as to the general accuracy and integrity of the records?

Summary

Outside of the fact that all witnesses exclude widespread collusion either definitely or by implication, there, seems to be a considerable divergence in the opinions expressed. This may be due entirely to phrases used or greater or lesser willingness to be definite on a subject as dangerous as this one. Nevertheless, some are quite definite that this type of examination should ordinarily disclose substantial recurring fraud and that it has been their experience that this type of examination has done so. Others concur in that opinion, although not quite as definitely. Still others straddle the question even farther but are rather careful not to say that the examination would not disclose fraud. Only three are rather definite on the side that examination is not expected to disclose fraud.

It is a fair implication from the testimony that the general feeling is that the examination should ordinarily disclose fraud, particularly that which results in overstatement of assets or understatement of liabilities, and that it will ordinarily disclose fraud where the asset and liability accounts are not affected if it is substantial and recurring. It is an equally fair assumption that the feeling was that the general type of the examination does not need to be changed for this purpose of fraud and irregularity except as is brought out with respect to two or three specific things later on. In other words, the general feeling of the witnesses is that the philosophy of this type of examination is entirely proper.

Question $•/—Do you consider the cash program outlined on pages 11 and 12 a minimum or maximum procedure? Can you indicate briefly what steps therein you ordinarily omit, and what additional steps you include?

Summary

Generally speaking, the procedure outlined in the bulletin is a minimum requirement for medium-sized companies. The amount of work to be done depends upon whether or not there is adequate cash control. Some witnesses put no emphasis on inspecting duplicate deposit slips while others do consider this important. All steps outlined in the bulletin are not invariably followed, but are followed, with variations, in most cases.

Questions 93 and $4—Looking to the future: (93) what procedures do you think auditors should use in verifying the quantity, quality and condition of inventories? (94) do you think auditors should participate in, or supervise the process of inventory taking by the company?

Summary

There seems to be general agreement that the auditors can more frequently participate in the determination of inventory quantities than they have. There is a recognition of the fact that this is sometimes impractical, that the accountant can not completely verify the inventory, and that the tests are not a complete guarantee of accuracy. The practical difficulties are indicated to be great enough to prevent mandatory rules for participation in inventories. One thought the answer might be in stating definitely the extent of the work on inventories rather than merely a negative statement.

Question 108—Is it customary to have the statements and working papers reviewed by anyone other than the person actually supervising the audit?

Summary

There is unanimity of opinion that the statements and working papers are always reviewed by some one other than the person supervising the audit. The question seems to be answered generally and reference is made to questions 109-110.

There are a number of questions with respect to the accountant's certificate, the answers indicating a rather general feeling that some improvement could be made in the certificate which had become reasonably standard:

Question 1/5—Is it your understanding that the second sentence (A) is intended to be a reasonably comprehensive statement as to the scope of an examination in conformity with the bulletin?

Question 116—Do you believe that any material omissions from the program indicated in the bulletin should be indicated in the certificate?

Summary

Most witnesses, believe that the wording is generally understood to cover examination such as that indicated by the bulletin, although there is some indication that the wording is not satisfactory.

There is quite complete agreement that any omissions in the scope of the work from that laid down by the philosophy of the bulletin should be definitely brought out in *the* certificate, but it is equally strongly pointed out that where the scope of examination is not satisfactory on important points, probably no certificate should be issued.

Question ny—Do you believe that the certificate should indicate any limitations contained in the audit engagement? What is your opinion if such limitations relate to steps which are required by the bulletin? As to steps which the bulletin leaves to the discretion of the accountant or which are optional under certain circumstances?

Summary

The witnesses generally agreed that only those limitations on the minimum procedure "not thoroughly justified by peculiar conditions" should be mentioned in the certificate. Two witnesses, Bailey and Bell, further stated that if the omissions were of such importance that the accountant could not assure himself of the client's position, then no certificate should be given. All witnesses expressed the opinion that the accountant should do all he thinks necessary in order to certify, or no certificate should be given.

Question up—According to the introduction to the accountants* report at *the* bottom of page 40, matter may be included in the accountants' report or in the statements for the purpose of being "merely informative," or to state limitations on the scope of his work, or to "indicate dissent from particular practices of the company." How is a reader to determine as to particular matter which of these purposes is intended?

Summary

The witnesses agree that exceptions should be stated in the opinion paragraph and that if they are not so stated they are not to be considered as an exception. Witnesses all agree that the responsibility of the accountant is to state either the limitation or the exception so clearly that there can be no misunderstanding of whether the accountant intended to take an exception or not.

Question 120—The statement, "inventories have been certified as to quantity, quality and condition by responsible officials of the company" falls into what category?

Summary

With minor exception, the witnesses all agree that the term "certified by management" or "quantity, quality and condition determined by management" is informative and not intended to be a qualification unless it appears in the opinion paragraph of the certificate. In that case, the answer must be considered in the light of the answers to 117, which show a general acceptance of the principle that if an exception is intended, it must be clearly stated.

Question 122—Is it customary for a representative of your firm to appear at directors' meetings at which the audited statements are presented, and at stockholders' meetings? Have you an opinion as to the desirability of such a practice?

Summary

Only one indicated any past preference for such a policy, but all, including that one, stated that it was not done so frequently that it could be said to be customary. All advocated it for the future, though some limited it to times when there might be important matters to discuss.

Question 124—Do you feel that auditors should point out in the statements significant developments or changes during the period audited? Should the auditors also analyze these changes and present their conclusions and recommendations to the company? Should these also be included as part of the statements? Do you follow this policy?

Summary

Witnesses agree that important financial changes should be called to the attention of the management, either by having the changes shown in comparative statements or a letter to the management. Witnesses are divided as to whether this is always done on all audits. One witness states that in an efficient organization the comptroller's department is more familiar with the significance of the changes than the auditor, and that these changes should be analyzed and set forth monthly by the comptroller's department.

Question 126—Would you say that present day auditing procedure is mostly concerned with determining that generally accepted accounting principles and conventions have been followed in the accounting records of the company?

Summary

Most of the witnesses testified to the effect that the emphasis is still on the authenticity of the accounts and the fairness of the presentation, but that there is an increasing tendency toward placing emphasis on the accounting principles and practices and the conventions.

The Institute's committee, to which reference is constantly made, also included in its report a suggestion for a new form of certificate, with its reasons for the recommendation. I think the most significant change, aside from the changes of wording to clear up ambiguity, is that which places the responsibility for the adequacy of the examination of the records sharply on the accountant. The certificate reads as follows:

> We have examined the balance sheet of The XYZ Company as of April 30, 1939 and the statements of income and surplus for the fiscal year then ended, have reviewed the accounting procedures of the Company, and have examined or tested accounting records of the Company and other supporting evidence by methods and to the extent we deemed appropriate in view of the system of internal control.
>
> In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939 and the results of its operations for the fiscal year, and reflect the application of accepted accounting practices on a basis consistent with the preceding year.

It is part of the report that, if the accountant does not follow normal procedures with respect to confirmation of inventories and receivables, he shall so state and make the necessary explanations or exceptions in his report. The implication is given that additional paragraphs may well be added to this accountant's report covering scope of work, explanations or special items. Emphasis is made that qualifications or exceptions must be clearly stated to distinguish them from mere explanations. The certificate committee of the. American Institute expects to proceed with the study as to whether additional suggestions as to the wording of accountant's certificate should be issued for special cases, small companies, etc.

The subject of accountants' certificates should not be dropped without reference to the pronouncement of the American Institute's committee on certificates, to the effect that it seems inconsistent if not actually misleading to express in the certificate the opinion that the financial statements fairly present, etc., when those words can only be considered in connection with and are negatived by qualifications of a material nature relating to the balance sheet items.

Nor should any discussion of recent developments in accounting and auditing be closed without speaking of the work of the American Institute Committee on Accounting Procedure, with a recently organized research staff which is trying to move forward in determining preferred or accepted procedures where conflict of thought now exists. The work of this committee should do much to clear up differences of accounting practice that are now confusing to the public.

In conclusion, I think we will find that the present inquiries into accounting and auditing procedure will not disclose that auditing has broken down under the stresses and strains of modern business. There is work to be done before auditing and accounting fully perform the service expected of them. Standards must be constantly raised. The errors due to lack of care or lack of knowledge must be constantly reduced. The general level of professional practice must be constantly raised. The accountants are facing their problems seriously and with a determination to conquer them, and I, for one, feel sure that the certified public accountant will be constantly developing his practice to meet the ever-changing conditions.

CHAIRMAN MADDEN: I know I express every one's opinion that we all appreciate the way in which Mr. Bailey approached this subject and brought us up-to-date very quickly and yet very broadly on these important meetings and conferences that have been held.

I am going to ask your indulgence to defer discussion or questions on his paper until after Mr. Marsh gets through. I know that some of you have questions to ask him. If you have not, I have, and so in order to keep me quiet, you will have to ask the questions.

We now have the privilege of listening to Mr. William F. Marsh, of Lybrand, Ross Brothers and Montgomery, of Pittsburgh.

AUDITING PROCEDURE—A DEVELOPMENT TO MEET CHANGING CONDITIONS

By WILLIAM F. MARSH, C.P.A.
Partner, Lybrand, Ross Bros., & Montgomery, Pittsburgh, Pennsylvania

When Professor Taylor invited me to appear on this program on the general subject of "Auditing Procedure, a Development to Meet Changing Conditions," he suggested that I deal principally with that phase relating to the verification of inventories, because Mr. Bailey would be asked to cover the verification of assets other than inventories. Mr. Bailey is from Detroit and I am from Pittsburgh, and we have had no opportunity to discuss the inter-relationship of the papers.

At the outset, I think *it* might be well to scrutinize and comment to some extent on the general topic. As you probably know, organized professional accountancy in America recently celebrated its Fiftieth Anniversary. During that period, accountancy has had a remarkable growth, and throughout that entire period of time I assure you there have been continually changing conditions. In that period, the investor or credit grantor has come to look upon the public accountant as the principal source of independent information and unbiased opinion concerning the position and operation of a business.

Recognition of the profession has brought increased responsibilities, and these responsibilities have willingly been assumed. As time has gone on, additional legal responsibilities have been gradually recognized, but the self-imposed moral responsibilities of the profession and standards of professional conduct have been always in advance of the legal liabilities. The profession is proud of its record of independence to express individual convictions *in* each particular case and its insistence to seek and tell the truth.

It must be kept in mind that accountancy is not an exact science, and, consequently, uniform standard procedure cannot be laid down by the profession nor by any other body. Regulatory bodies of the Government have been and are rendering the profession a great service in urging that accountants give serious thought to the promulgation of a set of principles and rules to cover accepted accounting procedure. Much progress has been made in that direction, particularly in very recent years.

Most of you are undoubtedly familiar with the *Statement of Accounting Principles* recently compiled by three leading educators of the country, which was published by the American Institute of Accountants. This publication, while not an official expression of the profession, has been a most valuable contribution and has provoked genuine interest and constructive discussion throughout the country. It is hoped, however, that care will be taken not to impose too much regulation, because no standardization can eliminate the *need* for initiative, judgment and honesty in the treatment of particular items or cases.

As most all of you know, in 1936 the American Institute of Accountants published a bulletin, *Examination of Financial Statements by Independent Public Accountants;* which was a revision of a similar bulletin prepared in 1929 by the American Institute and published by the Federal Reserve Board. The first such pamphlet was distributed by the Federal Reserve Board *in* 1918. Auditing procedures contained *in* those bulletins are intended to indicate what, at the time of their publication, were considered to be generally accepted practice. They are not intended to supplant the exercise of initiative and judgment on the part of the practitioner. In the case of an examination requiring a report upon financial statements to be issued to stockholders, or for credit purposes, the aim of the accountant is to establish a reasonable ground for the belief or opinion set forth in his report. Sound opinion is rarely based alone on any set formula or routine procedure.

It seems to me that auditing procedure has kept pace with the growth and development of industry. The established custom of making test checks of accounting records and related data and reliance upon the client's system of internal check and control, after ascertaining that such internal control is adequate and effective, has generally proved sufficient for its purpose. Because of the recent disclosure of facts existing in certain cases, and discussion of those cases in the press, there is now before the profession a question as to whether its procedure shall be extended. As a result, the American Institute of Accountants appointed a Special Committee on Auditing Procedure which, I understand, worked in conjunction with a similar Committee of the New York State Society of Certified Public Accountants. That Committee reported to the Council of the American Institute about ten days ago, and the Council adopted the report of the Special Committee as a statement of the best practice for the future with regard to the particular matters dealt with, among which was the examination of receivables and inventories. In its report, the Committee commented that in order to intelligently consider the question of extending procedures there must first be some general understanding of certain fundamentals. Those fundamentals are extremely important, and I am going to take the liberty of quoting from the Committee's report:

In the performance of his duties as auditor the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The function of the independent certified public accountant is to examine a concern's accounting records and supporting data; in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.

Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts for the proper recording of transactions in the books of account and for the safeguarding of the assets of a concern. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations.

In order to qualify himself to carry out his function the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience, that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice he encounters a wide range of judgment *on* the part of management, varying from true objective to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. Experience shows that, with few exceptions, the personnel of business organizations is honest. The discovery of defalcations has not been a primary objective of an examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant, although such discovery has frequently resulted. In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to satisfy himself that the system of internal check and control is adequate and sufficiently effective to justify reliance thereon. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry.

In carrying out his work the independent certified public accountant must always be on his guard against collusive fraud and be alert in detecting any sign of such collusion. However, on the basis of his examination by tests and checks, he relies upon the integrity of the client's organization unless circumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

In the judgment of this committee the independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, and that they conform to generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and if appropriate his reasons for omitting an expression of opinion.

INVENTORIES

Commenting specifically on procedures for verification of inventories, the Committee said:

The added steps that may well be taken to give greater assurance with regard to inventory quantities will vary in different circumstances but, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials. The public should understand that, while he can take steps to warrant the expression of his opinion as an accountant that stated quantities of merchandise are actually on hand, such procedure does not invest his opinion with a degree of authority which he does not claim for it, or impose upon him a measure of responsibility which the nature of his work does not justify.

Your committee believes that corroboration of inventory quantities by physical tests should be accepted as normal audit procedure. The manner and extent thereof will necessarily vary with the circumstances, because the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied to book records and to the procedure of taking physical inventories.

In cases where the inventory is determined solely by means of a physical count at the end of the accounting period it will be necessary for the test-checks of quantities to be made at that time. In some cases it may be practicable and satisfactory for the independent auditor to be present at the time of taking the inventory to see that a method, carefully thought out and established, and providing adequate internal check and control, is in fact being followed. Another plan which would be satisfactory where the circumstances permitted would be for the auditor to encourage throughout the year the continuous taking and checking of parts of the inventories against stock records, or other book records, by employees independent of the stockkeeping departments, and for the auditor to examine in whole or in part the reports on these partial checks and to participate in some of them.

The general, adoption of such added procedures regarding physical quantities of inventories may also necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar year basis that your committee doubts whether the profession as at present organized can undertake to make physical test-checks adequately and satisfactorily on the last day of each year. Many corporations do not have adequate perpetual inventory records and greater use of them should be encouraged.

The extension of procedures regarding inventories would be greatly facilitated if each concern adopted its natural business year instead of the calendar year as its fiscal year, and introduced continuous well kept perpetual inventory records.

The proposed changes will take time to bring about and your committee is of the opinion that in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures.

I hope it will not be assumed from the foregoing that in the past independent auditors have not made test-checks of inventory quantities. Such is far from the fact.

Public accountants have been making test-checks of the quantities of inventories for many years. It is true that the practice has become more prevalent during recent years, but I can recall having participated in checks of physical quantities of inventories twenty years ago.

It has been my conviction for several years that, in order to form an independent opinion as to earnings of a business enterprise where inventories are a material factor, the public accountant must in some way satisfy himself as to the substantial correctness of the quantities and condition of the inventories. Frequently, it seems to me to be especially desirable for the independent auditor to review the client's inventory instructions and procedure well in advance of the closing date. In my opinion, the most important phase of inventory-taking is the program, A carefully prepared plan of procedure, thoroughly understood by the men in charge, is more than half the battle. Frequently, it is decided to be essential to supervise the taking of a physical inventory, and in such cases our first consideration is directed to the preparations made in advance of the inventory date.

A review of the plan of inventory, and discussion with responsible representatives of the client in charge of taking and reporting on the physical inventory, would generally indicate whether the client intended to observe the points covered by the following questions:

1. When is the inventory to be taken?
2. Where are the locations of all goods to be inventoried?
3. Are all inventories on property owned or controlled by the client?

4. Have written instructions been prepared for the physical inventory procedure?
5. Who will make the original count of the quantities?
6. Will the quantities as originally counted be checked and, if so, by whom?
7. Do the employees who count the inventories know the exact nature or quality of the items counted?
8. Is the inventory to be taken while the plant is in operation or while it is shut down?
9. How are the items counted to be identified, viz., by tags, marks, or segregation?
10. Are the quantities to be listed on work sheets as counted?
11. Will original work sheets be signed by the persons making the count?
12. Will the work sheets be available for comparison with final inventory records?
13. Can quantities counted be spot-checked later?
14. How are the quantities and individual items counted to be tabulated and by whom?
15. Does the client keep perpetual inventory records available for comparison with physical count?
16. What goods on hand are on consignment?
17. Will consigned goods on hand be reported separately?
18. What goods are in the custody of others on consignment?
19. What goods are in transit?
20. Have all goods which were received, say during the last two weeks prior to the balance sheet date, been recorded on the Company's records as assets and the liability therefor been credited to vendor's accounts?
21. What goods are in public warehouses?
22. Are any customers' goods on hand for reprocessing or fabrication and, if so, is a separate record thereof maintained?
23. Has merchandise returned and on hand been credited to the customers' accounts?
24. What goods are obsolete?
25. What goods are spoiled and unsalable or salable only at reduced prices?
26. Are excessive quantities of certain merchandise on hand, and, if so, will they be properly identified in preparing the final inventory record?
27. Has all merchandise been shipped which was billed to customers prior to the balance sheet date?
28. Are there any indications that the quality of certain merchandise is different than that marked upon it?

29. Are there any vendors' bills in dispute which represent merchandise in stock but not recorded *in.* the client's financial records?
30. Has a responsible representative of the Company been designated to take physical inventory for the accounting department?
31. Where it is impractical to physically weigh certain inventories such as coal piles, scrap iron piles, etc., what rule or standard of measurement is used to estimate quantities?
32. Are consequential differences between physical counts and perpetual inventory records fully investigated and properly adjusted?

In the event that a review of the client's plan of inventory and records pertaining thereto indicates incorrect, inefficient, or unsatisfactory practices, or if unsatisfactory practices are noted during the course of the supervision of a physical inventory, which would cause us to doubt that the inventories are fairly stated from the point of view of the financial statements, we would in the face of such conditions, if a material amount is involved, be forced to qualify our report or, in an unusual situation, withdraw from the engagement.

After the procedure is agreed upon, superintendents, foremen, and assistant foremen ought to be called into a meeting and given an opportunity to make criticisms and suggestions. Once a thorough understanding of the program is reached by those actively in charge of the inventory-taking, the rest is comparatively easy. It is, of course, necessary to check the work as it progresses to see that the procedure is being faithfully followed; but once satisfied that this is the case, spot testing of results may be all that is required. I do not mean to imply that the testing of physical quantities, descriptions, etc., is unimportant; but the main thing is to see that the predetermined routine is thoroughly understood and actually followed.

Naturally, inventory procedure will differ from plant to plant; but no matter what individual problems there are, it is always possible to lay out a carefully considered plan, make sure that those immediately in charge of the work understand the plan, and then make tests, preferably while the inventory is being taken and again at its completion, to see that the plan has been carried out.

There are certain elements, however, which will appear in all such plans. These include the cut-off between departments and at the shipping and receiving platforms, methods of taking and of listing stock, the recording of additions and withdrawals if slow-moving stock is taken in advance of the inventory date, accounting for in-transit materials, checking of scales, clean-up of departments and reporting of scrap—in short, every condition that can affect the accuracy of the inventory. All of such things must be considered as a part of the preliminaries—as a part of the plan.

The procedure should be pointed to the end that the actual counting of the stock should consume a minimum of time. To accomplish this very desirable result, the client should take sufficient time to properly arrange the stock, and where the stock readily lends itself to tagging, prenumbered tags giving exact identification by code or complete description should be affixed in advance.

The procedure for assembling the results of the physical counts should provide for immediate comparison with the quantities shown on the perpetual records.

As I have said before, the public accountant should not rely solely upon physical tests reported. We cannot overlook the fact that large piles of bulk materials, fuel, etc., may not contain what the records call for or what their exterior indicates, and that chemical analyses might reveal them to be of inferior grades. Containers may be counted, yet the accountant may have little knowledge of their contents. Large and costly castings may be defective and destined for the scrap pile after inventory is taken; and there may be little demand for seemingly salable merchandise. Also, it should be kept in mind that a physical check will not reveal that certain materials are stocked far in excess of any requirements.

Manifestly, in large engagements, the public accountant can personally observe the counting of only a small fraction of the quantities. Tests other than physical may be fully as effective and should not be neglected. When the operations of the client are confined to a few lines, or where sales and costs of sales are departmentalized, the "gross profit test" can be applied to substantiate the reasonableness of inventories and to reveal unusual trends, the reality of which should be subjected to investigation. The quantities, moreover, should be reviewed in the light of whether the turn-over obtained since the last physical inventory is reasonable. Manufacturing capacity, warehouse and store-room capacities, production rates—numerous conditions have the effect of setting maximums which the inventories cannot exceed. Sales taxes paid and insurance coverage may also furnish the public accountant with evidence, although these are not exact tests, being limited in their application to large discrepancies.

I repeat, the auditor should strongly counsel that continuous checking of sections of the inventory against book records by employees independent of the stock-keeping department employees should be a part of the established routine of the client, and also that reports of such checking be preserved for review by the public accountants.

In the public hearings on auditing procedures held by the Securities Exchange Commission, which Mr. Bailey has summarized in considerable detail, one of the major topics on which the twelve expert witnesses testified was the accountant's responsibility for inventories.

There was agreement among the witnesses that the auditor should satisfy himself that the inventory had been priced in accordance with accepted accounting principles. Questions brought from the witnesses a description of the meaning of the term "market," as used in the phrase, "cost or market, whichever is lower/' that market price may be determined by one of two methods, depending upon prevailing circumstances: (I) Price in the trade in which the product is sold, as determined by quotations from reliable sources, less selling expenses, or (2) replacement or reproduction cost.

In discussion of the phrase "cost or market, whichever is lower," it was brought out that cost may be determined by any one of several generally accepted methods, among them, first-in first-out, last-in first-out, average cost, and normal stock. That prompts me to comment to some extent on various methods of costing inventories:

1. *Specific costs*—practicable for very few businesses of any size; the business of a diamond merchant would be one in which it could readily be used;

2. *Average cost*—usable especially in industries having a comparatively small number of different materials or products, as *in* a blast furnace or a cement manufacturing plant;

5. *Base stock*—a stated quantity of material or product is regarded as a continuing necessity for the business, and is priced at a conservatively low price which is maintained unchanged from period to period; only any excess of stock over the fixed quantity is priced at current costs. Copper and some other nonferrous metal industries have been among the principal users of this method;

4. First-in, first-out—assumes that, when goods are so intermingled that they cannot be identified with specific invoices, those first purchased or produced are first used or sold, regardless of whether or not this be the actual fact. This is the method which is probably *in* most general use;

5. *Last-in, first-out*—assumes that (in case of intermingling as in the case of first-in first-out) the goods used or sold are those which were most recently purchased or produced. This method is used in many of the major oil companies;

6. Standard costs—an estimated and predetermined cost, based upon specifications for material and direct labor, and an overhead allowance not in excess of that appropriate to a normal level of operating capacity; however, in determining material costs under this method a selection must be made from the several methods above described;

7. *Retail method*—used by department stores and many other retailers; inventories are determined, departmentally, by taking that percentage of the inventory at retail prices which the opening inventory (less deduction for mark-on), plus cost of goods purchased during the period, bears to the opening inventory (at retail) plus purchases for the period as priced at retail, including mark-ups.

Costs, moreover, are sometimes difficult to obtain, so that in cases where technological or other conditions have made it impractical to accumulate costs of individual items of manufacture, it may be necessary to use the sales value of the production as the starting point. In such cases, cost may be approximated by deducting, from the aggregate sales value of the production, shipping and other costs yet to be incurred and the estimated average gross profit which it is expected will be made. Where the products in the inventory have all been produced within the same production cycle—for example, within the two months preceding the inventory date—the computed gross profit margin for this period is used; where it is probable that a substantial part of the products have been carried over for longer periods, the computed margin of gross profit for six months or longer is employed in order to minimize the effect of production fluctuations.

Having determined that the inventory is priced at cost, the accountant is bound by convention and conservatism to assure himself that the cost is not in excess of the market. Here, again, the true professional accountant will be guided by good judgment rather than rule-of-thumb. A mere public quotation of similar merchandise is no justification for a sweeping reduction of his client's inventory valuation. The accountant will ask himself, "Could my client replace his inventory, considering its quality and especially its quantity, at the present market?" Consider a seasonal business* The accountant may be asked to examine the accounts immediately after the industry's principal buying season. There will be a lull in the trade and consequent low prices to match against his client's costs. Rule-of-thumb would dictate a lowering of inventory valuations. But there are other considerations, other questions to be asked. Is it likely that the client could replace his inventory, considering its quality and quantity, at the low quoted prices? Will the client's sale prices be affected by competitors' price cuts due to the prevailing low market? Or is the position of the client's product so buttressed by trade-mark and advertising as to be able to ignore what may be a temporary price recession? Or, conversely, has the client overbought in the face of a falling market to such an extent as to weaken his competitive position and impair his credit standing?

Whatever basis the judgment of the accountant determines should be used, he must ascertain that the inventory at the beginning of the period has been valued consistently with that at the close, or if inconsistency exists, give notice in his statements of the effect of such inconsistency.

ACCOUNTS RECEIVABLE

The American Institute's Special Committee on Auditing Procedure also considered the examination of receivables with particular respect to confirmation. In regard to the question of confirming receivables by direct communication with the debtors, the Committee made the following recommendations:

(a) That hereafter, in cases where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as normal audit procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of obtaining such confirmations in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment; and

(b) That hereafter, where the independent certified public accountant for any reason has not made such confirmation, he shall make suitable explanation or exception in his report.

This point was also covered in the testimony of the experts at the hearing held by the Securities and Exchange Commission early this year.

The bulletin, *Examination of Financial Statements,* prepared by the American Institute of Accountants and published in January 1936, contained this statement in commenting on procedure for auditing accounts receivable:

> The best verification of accounts receivable is to communicate directly with the debtor regarding the existence of the debt, and this course may be taken after arrangement with the client. While such confirmation is frequently considered unnecessary in the case of companies having an adequate system of internal check, it is one of the most effective means of disclosing irregularities. If it is to be undertaken, mail personally the requests for confirmation, after comparing them with the lists of outstanding accounts, in envelopes bearing the accountant's return address and enclose return envelopes addressed to the accountant.

The witnesses at the Securities Exchange Commission hearing were questioned as to whether it was their understanding that the foregoing paragraph in the bulletin implied that receivables ordinarily should be confirmed. Ten of the twelve witnesses agreed generally that the sentence quoted merely pointed out that confirmation was the most positive means of establishing the correctness of the balances but did not imply that confirmations should necessarily be sent in all cases. All of the witnesses agreed that confirmations were desirable under certain circumstances.

Asked whether a record of collections prior to the completion of the audit affected their judgment as to the desirability or necessity of confirming receivables, all ten witnesses to whom this question was put agreed that collections of accounts subsequent to the balance sheet date but prior to the completion of the audit affected their judgment, to some extent. One witness said he did not feel it necessary to confirm the accounts collected during the first few days after the balance sheet date; another, that subsequent payments were of value, particularly if they are supported by correspondence or other documentary evidence. Three of the witnesses did not feel that subsequent collections would affect the desirability of confirming, but indicated that they might exclude the "paid" accounts from their confirmation tests.

In stating their opinions on the value of collections subsequent to the balance sheet date, the majority of the witnesses qualified their responses to indicate that the auditor could not be too reliant on the book records of the subsequent collections, and stated that he would have to ascertain that funds were actually received and deposited.

The witnesses were also asked their opinion as to the relative value of the various forms of confirmation; that is,

(a) positive confirmation of as many accounts as is reasonably possible,
(b) positive confirmation either of a fair sample or of all large accounts and a sample of all others,
(c) negative confirmation as to all accounts.

The responses of the witnesses may be split into three general groups, each group favoring one of the methods set forth in the question: Six favoring method (a)—positive confirmation of as many accounts as is reasonably possible; each of the six, however, gave method (b)—positive confirmation either of a fair sample or of all large accounts and a sample of all others—second choice. One of the witnesses conceded that method (c)—negative confirmation; that is, requesting the debtor to reply only if the account is incorrect—might be the only practical measure if confirmations of a great number of relatively small accounts were sought. Two of the witnesses did not have much respect for the negative confirmation, one "supposing" it was cheap and might have some value.

One of the witnesses thought there was not much difference which method was used, although he favored the method (a)—positive confirmation of as many accounts as is reasonably possible. He believed negative confirmation of many accounts was less expensive and quite satisfactory if carefully done.

Four of the witnesses favored positive confirmation either of a fair sample or of all large accounts and a sample of all others—method (b)—as a practical matter, but two of them indicated that the added cost of the positive confirmation of all accounts was one of the considerations which led them to favor the method of positive confirmations of all large accounts and a fair sample of others. All four of these witnesses recognized negative confirmations as being of value, but not *to* the same degree as positive confirmations. In this connection, one of the four stated that positive confirmations invited responses more forcefully than negative confirmations, and "if there is no response, you have got at least the equivalent of the negative." On the added question of whether the absence of responses to requests for positive confirmation would be any indication that the accounts might be irregular, one of the witnesses stated, "Theoretically, yes; practically, no."

Two of the twelve witnesses favored negative confirmations for general use, but one of these excepted customers' accounts of brokerage houses; 01? these he favored the positive type of confirmation. The other's reaction was that the negative method was not only much cheaper but would be just as effective as positive confirmations in disclosing irregularities. The proponent of the negative type of confirmation felt that the difficulty of the positive type was that responses are not received on all requests, and the auditor is then saddled with the problem of deciding whether it is safe to proceed without having a definite reply from all customers. He conceded that a positive confirmation was more informing than failure to receive a reply to a negative confirmation as definite indication of the customer's agreement as to the balance. He pointed out, however, that the auditor might receive a spurious response to a request for positive confirmation of a fictitious account.

PLANT

The representative of the Securities and Exchange Commission also raised the question as to how the accountant determines that amounts capitalized as plant additions represent real additions, and how he determines that plant units have been abandoned and should be removed from the property account.

It seems to me that the method of ascertaining whether amounts capitalized represent real plant additions and whether abandonments are recorded is a matter of judgment, not rule. Ordinarily, the propriety of charges to plant accounts would be substantiated by examination of authorizations, corporate minutes, vendors' invoices, changes in production methods and other documentary evidence. If there is any doubt as to the propriety, the auditor should be expected to make inquiry of operating employees, such as maintenance men, plant superintendents, etc. Although it is not ordinarily essential to make a physical inspection of the plant, it seems to me a desirable procedure, if it is feasible.

As to whether the abandonment of certain plant units has been recorded, the auditor is expected to obtain some knowledge as to whether plant additions represent replacement of units abandoned, from the records and also by inquiring of responsible employees or officials. It does not seem to me to be necessary for an auditor to make a physical verification of major items which the books reveal to be nearing the end of their useful lives. On the other hand, I think adequate inquiry should be made where substantial amounts of property investment are indicated as having been in service for a period equal to its normal estimated life.

I hope, by these rather detailed comments on certain phases of auditing procedures, that I have not created the impression in your mind that auditing procedures can be reduced to a formula. Accounting rules are fairly well standardized in regard to the bulk of accounting transactions, but, as I said before, no set of rules of procedure is effective unless such rules and standard procedure are supplemented by sound judgment.

CHAIRMAN MADDEN: NOW, gentlemen, we have had two very fine papers at this meeting, both by partners of large firms and both by men who have to deal with these things during the trying days of these investigations, and I know that some of you have questions that you would like to ask them, either drawn from your personal experience or relating to these new procedures. So let's have a few questions.

There seems to be a little bit of backwardness in coming forward on the occasion. Perhaps there are no questions, perhaps the papers have been so well done that the last word has been said.

Well, gentlemen, I think that if you have no questions to ask, I will not keep you here by asking any myself.

I think the Interstate Hosiery Case was very fairly decided by the S.E.C. That, of course, involved the firm in New York who had a principal senior who went haywire, although in that particular case the rules of auditing procedure were violated by the firm because they did not rotate the senior in charge of the engagement. All of the rules and regulations, of course, that are being drafted nowadays are subject to interesting exceptions.

I recall the case in 1913 of a pharmaceutical company in New York which had an inventory increase that year beyond all bounds. On December 31, 1913, the inventory was four times larger than it had ever been before. At the same time, that company which ordinarily had a cash balance of $800,000.00 had got its cash balance down to $75,000.00. It seems that they had increased accounts payable to prodigious proportions. Well, in that situation, an accountant would comment, I presume, on the fact that the inventory had increased tremendously, that, in his opinion, it was all out of proportion to sales, and so forth. The worst of it was the inventory was still coming in during the first few months of 1914.

But, on August 1st, 1914, the World War broke out and this inventory of carbolic acid and citric acid and other acids became worth four times or three times the cost to the concern, and when we went through the War, the concern was 80 per cent German-owned. What an accountant would do with an inventory of that situation! They knew better what they were doing than accountants could possibly know. So you may have all kinds of situations dealing with inventories. Compelled by rules to do certain things, you may perhaps make yourselves foolish sometimes.

Well, gentlemen, are there any questions? If not, then I think I will exercise the privilege of the Chairman in thanking from your hearts, both of our speakers, and congratulating you upon the rapt attention with which you have listened to them.

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